S. Hrg. 98-831

THE INSIDER TRADING SANCTIONS ACT OF 1983

HEARING

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

COMMITTEE ON

BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

SECOND SESSION

ON

H.R. 559

TO AMEND THE SECURITIES EXCHANGE ACT OF 1934 TO INCREASE THE SANCTIONS AGAINST TRADING IN SECURITIES WHILE IN POSSESSION OF MATERIAL NONPUBLIC INFORMATION

APRIL 3, 1984

Printed for the use of the
Committee on Banking, Housing, and Urban Affairs

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Additional Material Supplied for the Record

THE INSIDER TRADING SANCTIONS ACT OF 1983

TUESDAY, APRIL 3, 1984

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, D.C.

The subcommittee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Alfonse M. D'Amato (chairman of the subcommittee) presiding.

Present: Senators D'Amato and Proxmire.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. The hearing on the Insider Trading Sanctions Act will come to order in the Securities Subcommittee.

Today's hearing will consider legislation formulated to deter insider trading. There are two approaches before us. One is H.R. 559, a bill passed by the House which authorizes the imposition of up to a triple penalty for insider trading. H.R. 559 does not include a definition of insider trading. Instead, it relies on case law growing out of SEC antifraud rule 10b–5. The second approach is included in a draft which I offer for discussion. The draft before you is derived from an idea presented by Milton Freeman in his testimony last April before the House Subcommittee on Telecommunications, Consumer Protection and Finance. My bill would abandon the rule 10b–5 requirement that the SEC prove fraud and show that the trader intended to deceive or defraud investors to whom he owed a duty. Instead, it would create a new section in the securities laws to supplement rule 10b–5 which would simply proscribe the unfair use of inside information. The SEC would no longer be required to prove that the insider had a special relationship with the person he was trading with or that the insider intended to defraud the other party.

Insider trading is a blight on our capital markets. I concur wholeheartedly with John Fedders, the Director of the SEC's Division of Enforcement that insider traders are thieves. I also concur with Mr. Fedders' statement that insider trading is not a victimless crime. Even if the person who deals with the insider trader would have traded anyway the integrity of the market is the victim since it is seriously undermined.

The capital markets in the United States are noted internationally for their efficiency and integrity. Because of this, municipal and corporate borrowers from around the world rely heavily on our markets as a major source of capital. The perception that U.S. markets are relatively free from fraud and abuse fosters investor confi-

dence, which in turn increases the depth and liquidity of our capital markets. Failure to preserve the integrity of our markets could ultimately increase the cost of borrowing as investors seek investment alternatives which they perceive as fair.

SEC rule 10b–5 has been the Commission's basis for barring insider trading. The rationale is that corporate insiders owe a fiduciary duty to the shareholders and that the use of inside information to profit in stock transactions is a fraud against the shareholders. The Supreme Court, however, has narrowly construed the term "insider." Under rule 10b–5, various classes of traders fall through the cracks and are permitted to benefit from trading while in possession of material nonpublic information. Arguably current law doesn't cover most forms of options trading.

Clearly, the corporate executive who knows of record earnings and purchases stock before corporate earnings are publicized is an insider within the reach of the SEC under rule 10b–5. But what about the financial printer who uses the confidential information he obtains after breaking a secret code? According to the Supreme Court's 1980 *Chiarella* opinion, the financial printer is not guilty of insider trading because he is not an insider within the meaning of rule 10b–5. He did not owe any fiduciary duty to the corporation's shareholders. In *SEC* v. *Dirks* (1983), the Supreme Court ruled that there is no violation of the rule if the person using the information is not an insider and if he did not receive the information from an insider who received a personal benefit and breached a fiduciary obligation. This opinion leaves the door open to the unscrupulous to obtain material nonpublic information and to benefit without the fear of civil or criminal penalties, it also makes the SEC's job more difficult by requiring them to show that the tipper received a benefit. Finally, in recent weeks, we have seen insider trading involving outsiders and outside market information in the *Searle* case, and the *Wall Street Journal* case. The SEC has announced formal investigations of these cases, but I question whether the current law is adequate to deal with these situations.

In addition to not reaching all insider traders current law lacks deterrence. The harshest remedy the SEC may currently seek against an insider trader is disgorgement of the ill-gotten gain or loss avoided, and an injunction mandating that the violator observe the securities laws in the future. Clearly this provides little in the way of deterrence since violators only risk is being returned to their original position. I fully support a triple penalty for insider trading as well as an increase in the fine for criminal violations of the securities law from $10,000 to $100,000. My only question is how should we apply the penalty.

Since the House concluded their hearings last April I have attempted to sort out this problem. I solicited input from the Securities and Exchange Commission and even requested a draft of a definition of insider trading. My staff has discussed these issues with the SEC, the securities bar, the securities industry, and other concerned parties.

It is my hope that the dialog started last year will continue today and these hearings will provide a record for deciding the following issues:

One, whether the current law is adequate to preserve investor confidence by deterring or punishing those who trade while in possession of inside information?

Two, if we decide that the current law is inadequate, can we find a workable definition?

Three, if we decide not to create a definition, how do we apply a triple penalty to the existing law?

I thank all of the people who have contributed their time and effort in the last year in pursuit of a legislative solution which would protect investors and preserve the integrity of our capital markets.

[Bill H.R. 559 and draft of legislation proposed by Senator D'Amato follows:]

II

98TH CONGRESS
1ST SESSION

H. R. 559

IN THE SENATE OF THE UNITED STATES

SEPTEMBER 20 (legislative day, SEPTEMBER 19), 1983

Received; read twice and referred to the Committee on Banking, Housing, and Urban Affairs

AN ACT

To amend the Securities Exchange Act of 1934 to increase the sanctions against trading in securities while in possession of material nonpublic information.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. This Act may be cited as "The Insider Trading Sanctions Act of 1983".

SEC. 2. Section 21 of the Securities Exchange Act of 1934 is amended by redesignating subsection (d) as subsection (d)(1), and adding at the end thereof the following new paragraph:

"(2)(A) Whenever it shall appear to the Commission that any person has violated any provision of this title or the rules or regulations thereunder by purchasing or selling a security while in possession of material nonpublic information in a transaction (i) on or through the facilities of a national securities exchange or from or through a broker or dealer, and (ii) which is not part of a public offering by an issuer of securities other than standardized options, the Commission may bring an action in a United States District Court to seek, and the court shall have jurisdiction to impose, a civil penalty to be paid by such person, or any person aiding and abetting the violation of such person. The amount of such penalty shall be determined by the court in light of the facts and circumstances, but shall not exceed three times the profit gained or loss avoided as a result of such unlawful purchase or sale, and shall be payable into the Treasury of the United States. If a person upon whom such a penalty is imposed shall fail to pay such penalty within the time prescribed in the court's order, the Commission may refer the matter to the Attorney General who may recover such penalty by action in the appropriate United States District Court. The actions authorized by this paragraph may be brought in addition to any other actions that the Commission or the Attorney General are entitled to bring. For purposes of section 27 of this title, actions under this paragraph shall be actions to

enforce a liability or a duty created by this title. The Commission, by rule or regulation, may exempt from the provisions of this paragraph any class of persons or transactions.

"(B) No person shall be subject to a sanction under subparagraph (A) of this paragraph solely because that person aided and abetted a transaction covered by such subparagraph in a manner other than by communicating material nonpublic information. Section 20 of this title shall not apply to actions brought under this paragraph. No person shall be liable under this paragraph solely by reason of employing another person who is liable under this paragraph.

"(C) For purposes of this paragraph 'profit gained' or 'loss avoided' is the difference between the purchase or sale price of the security and the value of that security as measured by the trading price of the security a reasonable period after public dissemination of the nonpublic information.

"(D) No action may be brought under this paragraph more than five years after the date of the purchase or sale. This paragraph shall not be construed to bar or limit in any manner any action by the Commission or the Attorney General under any other provision of this title, nor shall it bar or limit in any manner any action to recover penalties, or to seek any other order regarding penalties, imposed in an action commenced within five years of such transaction.".

SEC. 3. Section 32 of the Securities Exchange Act of 1934 is amended by striking out "$10,000" in subsection (a) and inserting in lieu thereof "$100,000".

SEC. 4. Section 15(c)(4) of the Securities Exchange Act of 1934 is amended by inserting "14," after "section 12, 13,".

SEC. 5. The amendments made by this Act shall become effective immediately upon enactment of this Act.

Passed the House of Representatives September 19, 1983.

Attest: BENJAMIN J. GUTHRIE,

Clerk.

DRAFT OF LEGISLATION PROPOSED BY SENATOR D'AMATO

A BILL

To amend the Securities Exchange Act of 1934 to make unlawful unfair use of information in trading

(Insert title of bill here)

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

Sec. 1
Section 16(f). To Make Unlawful Unfair Use of Information.

(a) It shall be unlawful for any person who is in possession of material nonpublic information to profit from such information or avoid loss by purchasing or selling such securities or any securities, convertible into or exchangeable for such securities or options or rights to obtain or dispose of such securities, or to aid and abet any such person so to profit or avoid loss, if he employs the information in violation of his own fiduciary or contractual obligations, or if to his knowledge the information is imparted to him in violation of the fiduciary or contractual obligations of the person imparting such information to him.

(b) Notwithstanding anything in paragraph (a) to the contrary, the following transactions shall not be in violation of paragraph (a) of this section:

(1) Purchases of any security described in paragraph (a) by a broker or by another agent on behalf of an offering person; or

(2) Sales by any person of any security described in paragraph (a) to the offering person.

(c) No person shall be subject to a sanction under paragraph (a) of this section solely because that person aided and abetted a transaction covered by it in a manner other than by communicating material nonpublic information. Section 20 of this title shall not apply to actions brought under paragraph (a) of this section. No person shall be liable under paragraph (a) of this section solely by reason of employing another person who is liable under such subsection.

A person other than a natural person that employs another person who is liable under paragraph (a) of this section shall not be liable if such person shows that:

(1) The individual making the investment decision on behalf of such person to purchase or sell any security described in paragraph (a) did not know the material, nonpublic information; or

(2) Such person had implemented one or a combination of policies and procedures, reasonable under the circumstances, taking into consideration the nature of the person's business, to ensure that individual(s) making investment decision(s) would not violate paragraph (a), which policies and procedures may

include, but are not limited to, (i) those which restrict any purchase, sale of any such security or (ii) those which prevent such individual(s) from knowing such information.

(d) It shall not be necessary to establish a violation of this Section 16(f) that the acts made unlawful be proved to be done with any purpose to deceive, manipulate or defraud investors but only that the use of information was unfair as violating an express or implied obligation.

(e) Any person violating this section shall forfeit the amount of the profit gained or the loss avoided and shall pay an amount determined by the court in light of the facts and circumstances up to three times the amount of the profit gained or the loss avoided into the Treasury of the United States upon order of a United States District Court in an action commenced by the Commission under Section 21(a).

For purposes of this paragraph "profit gained" or "loss avoided" is the difference between the purchase or sale price of the security and the value of that security as measured by the trading price of the security a reasonable period after public dissemination of the nonpublic information.

(f) This section is in addition to any other provision of law and, particularly, shall not be deemed in any way to restrict the scope of sections 10(b) and 14(e) of this Act and the rules promulgated thereunder.

Sec. 2

Section 32 of the Securities Exchange Act of 1934 is amended by striking "$10,000" from subsection (a) and inserting in lieu thereof "$100,000".

Senator D'AMATO. Before we turn to our first panel, which is Chairman Shad, Mr. Fedders, and Mr. Goelzer, my distinguished colleague, Senator Proxmire, is here and I wonder if he has an opening statement.

Senator PROXMIRE. No, thank you very much, Mr. Chairman. This is a very, very important hearing and I am glad you're calling it and I look forward to the testimony.

Senator D'AMATO. Thank you.

Chairman Shad.

STATEMENT OF JOHN S.R. SHAD, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION, ACCOMPANIED BY JOHN FEDDERS, DIRECTOR, SEC DIVISION OF ENFORCEMENT; AND DANIEL L. GOELZER, SEC GENERAL COUNSEL

Mr. SHAD. Thank you, Chairman D'Amato. It is requested that our formal statement be included in the record.

Senator D'AMATO. It shall be.

Mr. SHAD. Chairman D'Amato, Senator Proxmire, and other members of the subcommittee: With me here today are John Fedders, the SEC's Enforcement Division Director, and Dan Goelzer, who is the SEC's General Counsel.

The Securities and Exchange Commission appreciates this opportunity to testify on S. 910 and H.R. 559 today, the Insider Trading Sanctions Act, passed by the House in September 1983.

This legislation would permit civil penalties of up to three times the profits gained or losses avoided when a person unlawfully purchases or sells a security while in possession of material nonpublic information.

It also increases the fines for most criminal violations of the Exchange Act from $10,000 as established in 1934 to $100,000.

INSIDER TRADING UNDERMINES PUBLIC CONFIDENCE

Insider trading undermines public confidence in the fairness of the securities markets. It victimizes not only individual and institutional investors, but also securities firms, corporations, and others. Option writers have incurred multimillion-dollar losses as a result of insider trading. Insider trading has also caused corporate tender offers to be modified, trading in securities to be suspended, and newspaper articles and investment adviser recommendations to be withdrawn and modified.

The reputations of leading law firms, securities firms, corporations, publications and others have been impugned by unscrupulous employees who have abused their positions of trust to take advantage of inside information.

As a result of the record volume of tender offers since mid-1981, the Commission has brought over 50 insider trading cases. They represent over 40 percent of all such cases that have ever been brought by the Commission.

Defendants have included corporate executives, attorneys, accountants, brokers, bank officers, members of their families, and many others.

The expanding options market and volume of tender offers have increased the opportunities to reap extraordinary profits with little

risk. Because of the leverage afforded by options, over hundredfold profits have been realized within 48 hours on inside information.

The Commission's principal enforcement remedy is a civil injunction against future violations and disgorgement of the illegal gains. Inside traders may also be subject to criminal prosecution, imprisonment and fines, civil suits by defrauded parties, disbarment, and license revocations, the loss of employment, and social opprobrium. However, these have not been adequate to deter those tempted by extraordinary profit opportunities.

The proposed legislation would dramatically increase the risk of insider trading. For example, under the present law, if A conveys inside information to B who realizes a $100,000 profit, A or B can be compelled to disgorge the whole $100,000. Under the proposed bill, in addition to disgorging the $100,000 profit B could be compelled to pay a fine of $300,000. A could also be fined $300,000. Thus, the total disgorgement and penalties could be increased in this example by sevenfold and in fact it could be much more than that if there were more parties involved—from $100,000 to $700,000 in my example.

On the other hand, the bill is not intended to inhibit legitimate corporate activities for the benefit of shareholders, or to increase compliance costs, which investors ultimately bear.

As passed by the House, H.R. 559 contains several amendments suggested by the SEC.

AMENDMENTS SUGGESTED BY SEC

First, penalty fines would be limited to those who trade while in possession of material nonpublic information or who tip such information.

Second, penalty fines would not apply to those whose liability is secondary or vicarious. For example, those who aid and abet insider trading other than by tipping would not be subject to the penalty, but they would continue to be subject to the SEC's present sanctions.

Third, the fine would be based on the price of the security a reasonable time after public dissemination of the information and would not take into account subsequent profits.

Fourth, Commission actions seeking imposition of the fine would be subject to a 5-year statute of limitations.

The Commission recommends that the bill be further amended to incorporate a present Commission rule that provides that multiservice firms that have effective Chinese walls are not liable for trades by employees shielded by such walls from information possessed by other employees.

The House bill would also grant the Commission the same administrative authority to address false and misleading proxy and tender offer filings as it has in the case of other filings.

The Commission has recently proposed similar legislation that also includes the authority to name the individuals who caused such violations.

The Commission was advised last week that the subcommittee has under consideration an alternative approach to the Insider Trading Sanctions Act that includes a definition of the conduct

that would be subject to the penalty. The Commission applauds Chairman D'Amato for his efforts to resolve the difficult issues raised by proposals to define insider trading. Some members of the SEC staff favor the amended version of H.R. 559 rather than the alternative approach, but the full Commission has not as yet had an opportunity to make a comparative analysis of the new approach with the existing state of the law, and some of the preliminary conclusions vary. Some would argue that the new approach is much simpler, has greater specificity, and in some ways is narrower; and yet others would contend that it's much broader and would bring into play a whole host of new charges and prospective defendants.

The Commission would like to have the opportunity to do a serious comparative analysis of the new approach with the present state of law and then submit pros and cons and its conclusions for your consideration, Mr. Chairman, and the subcommittee's consideration.

The other area that has been raised for today's discussion is waiver by conduct, which is an excellent concept. It has not as yet been considered by the full Commission. Questions can be raised concerning the cost and benefits of any new legislation. I raise this proposal for consideration in order to gain greater foreign support and cooperation for it. While some might characterize it as an extraterritorial application of our laws, it includes a reciprocal provision in which the United States would give similar treatment to foreign countries who are soliciting information concerning trades in their countries and many others in the United States. Also I think we would benefit from broad public exposure and the solicitation of comments.

Thank you very much. I'd be glad to respond to any questions.

WRITTEN STATEMENT OF THE HONORABLE JOHN S.R. SHAD,
CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION,
BEFORE THE SUBCOMMITTEE ON SECURITIES OF THE SENATE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
CONCERNING THE INSIDER TRADING SANCTIONS ACT

April 3, 1984

Chairman D'Amato and Members of the Subcommittee:

I. Introduction

The Securities and Exchange Commission appreciates this opportunity to testify on S. 910, the Insider Trading Sanctions Act of 1983. This legislation, proposed by the Commission, would deter those who injure the investing public and undermine the integrity of the securities markets by engaging in insider trading.

The bill would amend the Securities Exchange Act of 1934 to authorize the Commission to seek court awarded, civil money penalties of up to three times the profit gained or loss avoided when any person has unlawfully purchased or sold a security while in possession of material non-public information. The bill also increases the fines for most criminal violations of the Exchange Act from $10,000 (established in 1934) to $100,000.

The House of Representatives has acted on this legislation, which was introduced as H.R. 559. During its consideration of H.R. 559, the House made several amendments to the bill that clarify its intended scope, including limitations on secondary

liability and the addition of a statute of limitations and a definition of "profit gained or loss avoided." The House also added a provision that would authorize the Commission to institute administrative proceedings, based on violations of the proxy and tender offer requirements of Section 14 of the Exchange Act. The Commission supports the Insider Trading Sanctions Act as passed by the House on September 19, 1983.

II. The Nature of the Problem

"Insider trading" is the term used to describe purchasing or selling securities while in possession of material non-public information about an issuer or the trading market for an issuer's securities. Such conduct undermines the expectations of fairness and honesty that are the foundation of public confidence in the nation's securities markets.

The term "insider" includes corporate officers and directors and any other person who has a fiduciary or similar relationship of trust or confidence to the corporation or its shareholders. It also includes persons who, through some act or course of conduct, misappropriate material non-public information about an issuer. The term "inside information" is commonly used to include information concerning the corporation, its activities or performance, or events related to the market for the corporation's securities, such as a proposed tender offer.

Abuses by insiders and their tippees erode investor confidence in the securities markets. Public investors may be less willing to place their money at risk in securities if they believe that insiders, in possession of material non-public information, will utilize that information to take unfair advantage of those without such information.

Insider trading also has a substantial adverse impact upon market professionals. Market makers and specialists are exposed to substantial losses when trading with persons who possess inside information because they cannot make rational pricing decisions. In the past several years, option writers incurred multi-million dollar losses because they had to honor commitments to persons who had purchased options while in possession of inside information concerning an impending acquisition.

In order to curtail and deter insider trading, the Commission has sharply increased the number of enforcement actions against such conduct. In fiscal 1983, the Commission brought 24 cases involving insider trading. In fiscal 1982, the Commission brought 20 cases. This two-year total represents 35% of all the insider trading cases that have been brought by the Commission. Actions have been brought against corporate executives, attorneys, accountants, bank officers, members of their families and others who purchased securities while in possession of material non-public information concerning proposed tender offers, or other significant corporate developments.

The U.S. securities markets are the fairest in the world. Insider trading is the exception, not the rule. Nevertheless, despite vigorous enforcement efforts, insider trading continues to present an opportunity to reap huge profits with little risk of financial loss. Major tender offers and active markets in standardized option contracts permit several hundred thousand dollar profits to be realized within a few weeks on modest investments. The consequences of being apprehended should be increased in order to deter insider trading.

III. The Need for an Additional Remedy to Deter Insider Trading

(a) Recent increase in insider trading

The increasing size and number of mergers and tender offers have been an important factor in insider trading. The reaction of the market to the announcement of a proposed acquisition is predictable: the price of the stock rises rapidly toward the merger or tender offer price. Thus, persons with advance knowledge of a proposed tender offer or merger announcement have an opportunity to profit substantially in a short period of time without much risk of loss.

Another important factor in insider trading is the expansion of trading in standardized option contracts. Call option contracts for the purchase of common stock are issued in series fixing the month of expiration and the price at which the option contracts

can be exercised to purchase a common stock. Each call option contract in a series represents the right to purchase 100 shares of stock at a specified price by a specified date. Thus, a single contract for "October 25's" would entitle the holder to purchase 100 shares of an issuer's common stock for $25 per share until a specified date in October, after which the option would expire and become worthless.

The purchase of such options, rather than the underlying securities, enables a person in possession of material non-public information to maximize potential profits because the option price is generally a tiny fraction of the price of the underlying stock. Thus, a minimal amount of capital is placed at risk. However, once a tender offer or merger is announced, the value of an option contract tends to increase at a much greater percentage than the price of the stock. In one case, the Commission alleged that an individual invested $3,125 in call options of a corporation which was to be the subject of a takeover proposal. In 48 hours, the purchaser realized profits of approximately $430,000.

(b) Recent Enforcement Actions

Insider trading enforcement actions have involved information relating to corporate events and external events that affect the market for an issuer's securities. Corporate events have included changes in corporate earnings; changes in dividends;

significant corporate transactions such as ore strikes, approval of patents, joint ventures, settlement of litigation and entry into a particular line of business. External factors which have an impact on the prices of publicly traded securities have included mergers and tender offers; rates of government issued securities; recommendations by analysts and financial writers; and potential enforcement action by the Commission.

The Commission has instituted enforcement actions against different classes of persons for trading while in possession of material non-public information. These include issuers, officers, directors, and employees; principal shareholders; attorneys, accountants, investment bankers and employees of these professionals who trade in securities of their clients; officers and directors of bidders in tender offers; investment analysts; and financial printers.

The Commission's enforcement efforts against insider trading have been highly visible in the past few years. Cases brought by the Commission last year include SEC v. Dominick Musella, et al., 1/ and SEC v. Manohar Lal Madan, et al. 2/ The sources of the information in both cases were employees of major law firms that had taken steps to ensure that the information stayed secret.

In the Musella case, the Commission alleged that throughout 1981 and 1982, the manager of office services of the law firm

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1/ 83 Civ. 342 (C.S.H.) (S.D.N.Y. filed Jan. 11, 1983).

2/ 83 Civ. 5053 (M.E.L.) (S.D.N.Y. filed Jan. 7, 1983).

tipped information about plans of firm clients in order that a wide ring of friends and their relatives could trade. The Commission's complaint alleges profits of approximately $1.4 million.

In the Madan case, the Commission alleged that a word processing operator tipped relatives and friends and traded on information that he gleaned from documents he was typing at the law firm. The Commission's complaint alleges that one or more of these defendants purchased securities of at least twenty-nine companies from November, 1977 through November, 1982. The complaint alleges profits of approximately $2.6 million.

These cases illustrate the opportunities for profit inherent in the recent conjunction of tender offers and acquisitions with the availability of trading in standardized option contracts. These circumstances have fundamentally altered the risk-reward equation with respect to insider trading and demonstrate the need for a new enforcement remedy to deter such conduct. For example, in the Musella case, on trades in one target of a tender offer, one group of defendants made approximately an $872,000 profit from purchases of approximately $92,000 in options purchased the day before the announcement of the tender offer.

(c) The need for a civil penalty to deter insider trading

The Commission's principal enforcement remedy is a civil action seeking an injunction against future violations and

disgorgement of illegal gains by persons who have traded securities while in possession of material non-public information. 3/ A defendant who violates a court order can be punished in contempt proceedings.

In recommending enactment of the Insider Trading Sanctions Act, which would authorize civil money penalties of up to three times the profit gained or the loss avoided by persons who purchase or sell securities while in possession of material non-public information, the Commission pointed out that its existing remedies are not adequate:

> An injunction orders a defendant to obey the law in the future and subjects a defendant to the threat of contempt proceedings if he violates the law again. As such, it presents no significant hardship to the defendant because "[c]ompliance is just what the law expects." In view of this and the fact that they are prospective in operation, injunctions do not penalize the defendant for the illegal conduct for which the injunction was imposed. 4/

3/ The Commission has also instituted administrative proceedings against persons subject to its regulatory authority who have traded on inside information or who have aided and abetted persons who have traded on inside information. In addition, the Commission, pursuant to the authority conferred by the Securities Exchange Act, has made evidence of insider trading available to the Department of Justice for determinations as to possible criminal prosecution.

4/ The Commission memorandum in support of the bill is reprinted in 14 Sec. Reg. & L. Rep. 1704, 1706-07 (Oct. 1, 1982). The Commission quotes Walling v. Harnischfeger Corp., 242 F.2d 712, 713 (7th Cir. 1957).

The Commission also noted that, while it may seek disgorgement of illegal profits, this remedy merely "strips the defendant of the fruits of his illegal conduct and returns him to the position he was in before he broke the law." Thus, the Commission concluded, "it is necessary to raise the level of risk that potential insider traders face if insider trading is to be effectively deterred." 5/

The Commission recognizes that there are factors, in addition to Commission enforcement actions, that tend to deter persons from engaging in insider trading. For example, insider trading may subject a person to criminal prosecution by the Justice Department; imprisonment and criminal fines; civil suits by defrauded parties; disbarment, license revocation and other proceedings by professional and self-regulatory organizations; the loss of employment; substantial legal expenses; and social opprobria. Nevertheless, these factors have not provided sufficient deterrence because of the unusual opportunities for gain inherent in using material non-public information.

The proposed legislation would increase the risks associated with insider trading by authorizing the Commission to seek a court order requiring offenders to pay the Treasury of the United

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5/ Id.

States a sum up to three times the profit gained or loss avoided through illicit transactions. The Commission would be authorized to seek this remedy directly, and would not be required to obtain an injunction first.

By the same token, this legislation is not intended to inhibit legitimate corporate activities for the benefit of investors or increase compliance costs, which they ultimately bear.

Responsible corporate executives, securities brokers and others are responsive to the law. The risk of huge personal fines and the attendant adverse publicity may lead some to alter unnecessarily conduct they would otherwise take in the interests of investors, for fear of inadvertent violations. Dirks v. SEC 6/ makes it clear that an insider, who communicates material non-public information, violates the law only if he acts for a personal benefit in violation of his fiduciary duty. The bill as passed by the House continues this standard.

The potential inhibiting effects of a treble penalty are most acute for securities brokers, since virtually all securities transactions are executed through them. The bill as passed by the House addresses this concern by excluding stockbrokers from the treble liability, even if they execute transactions known

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6/ 103 S.Ct. 3255 (1983).

to be based on inside information. The treble liability is limited to those who actually trade while in possession of inside information or tip others. It does not apply to those who do not participate in the ill-gotten gains, such as stockbrokers who merely receive conventional commissions for executing transactions. While not subject to treble liabilities, such individuals continue to be subject to prosecution and administrative sanctions for violations under the present law.

IV. An Explanation of the Insider Trading Sanctions Act

(a) Civil penalty

As passed by the House of Representatives, the Insider Trading Sanctions Act would authorize the Commission to bring a civil action in federal district court, based upon insider trading, and seek relief in the form of a civil money penalty payable to the Treasury. The amount of the penalty would be in the court's discretion, but would be limited to a maximum of three times the profit gained or loss avoided through insider trading.

The new remedy could be used in lieu of, or as a supplement to, traditional Commission injunctive and administrative remedies. Thus, in an appropriate case, the Commission could decide to seek an "obey the law" injunction, disgorgement of illicit profits, and a civil penalty of up to three times the

amount of illicit profits. The court could exercise its broad discretionary powers in determining the disposition of disgorged funds (e.g., putting the money in an escrow account which could be used to compensate victims of the insider trading), but any civil penalty imposed would always be paid to the Treasury.

If a person fails to pay any penalty imposed within the prescribed time, the Commission could refer the matter to the Attorney General, who could recover the penalty in a separate action. Alternatively, the Commission could seek enforcement of the court order through contempt proceedings, as in the case of other court-ordered remedies available to the Commission.

(b) Scope of liability

The House bill limits liability for the civil penalty to those most directly culpable in insider trading violations. The penalty would be imposed on those who violate the federal securities laws by trading while in possession of material non-public information, and also on those who "tip," or communicate material non-public information to others who trade, even if those tippers do not trade.

The civil penalty sanction would not apply to persons whose liability is otherwise secondary or vicarious. No person would be subject to the sanction solely by reason of aiding and abetting a transaction, other than by communicating material nonpublic information. Section 20 of the Exchange Act, which makes

controlling persons liable along with those they control, would not apply to actions for the civil penalty. Similarly, no person would be liable for the penalty solely by reason of employing another person who is liable for the penalty. The legislation would not change existing law with respect to other Commission remedies that may be used against these classes of law violators.

While the legislation excludes from its coverage broker-dealers and their registered representatives who do no more than execute trades for customers who are trading unlawfully, a registered representative could be liable for the penalty as an aider and abettor, if he learned the information in question from one customer and then tipped other customers who traded. If the representative unlawfully tipped other customers, the firm employing the representative would not be liable for the penalty, although it may be subject to injunctive relief on theories of vicarious or secondary liability. The registered representative and firm also might be subject to administrative sanctions under the securities laws.

In appropriate circumstances, corporate entities, employers and control persons could be directly liable for the civil penalty. For example, if the board of directors of a corporation, while in possession of material non-public information, directed

an employee to trade for the corporation's account, the corporation itself would be liable for the penalty. In that situation the corporation would not be an aider and abettor, but would be a primary violator.

However, the Commission believes that, consistent with existing law, a multi-service firm with an effective "Chinese Wall," should not be liable for trades effected on one side of the wall, notwithstanding inside information possessed by firm employees on the other side. The Commission contemplates that it would use its rulemaking authority under the bill to adopt a rule similar to Rule 14e-3, which created such a safe harbor for multi-service firms in the context of impending tender offers.

(c) Definition of profit and loss

For purposes of penalty actions, the House bill defines the profit gained or loss avoided as the difference between the purchase or sale price and the price a reasonable period after public dissemination of the information.

The Commission believes that this is an appropriate measure for purposes of the penalty action. The ability of a court to impose a penalty up to three times the profit gained should provide sufficient flexibility to assure that the defendant does not retain the benefit from his wrongful conduct.

(d) Statute of limitations

A five-year statute of limitations for penalty actions was added to the House bill. This conforms to the five-year statute of limitations for criminal violations of the Securities Exchange Act, although there is no statute of limitations for Commission actions under the Exchange Act. The usual purpose for a statute of limitations is that, after the passage of a significant period of time, the defendant should not be put to the task of defending against charges when witnesses' memories may be dim and relevant documents unavailable. Because of the potentially heavy penalty under the bill, similar reasoning may justify a statute of limitations for penalty actions.

The five-year statute of limitations would have little practical effect on penalty actions because, in most instances, the Commission discovers insider trading, if at all, soon after it occurs.

(e) Other issues

During the House debate other issues were discussed including the burden of proof for penalty actions and a right to a jury trial. The House rejected a higher burden of proof and a right to trial by jury.

The burden of proof in injunctive actions brought by the Commission is preponderance of the evidence. This standard also applies in private damage actions. The Commission opposes

a higher burden of proof in penalty actions because it would make the prosecution of insider trading actions more difficult and thus would reduce the number of successful penalty actions. Most insider trading cases are, by their nature, based largely on circumstantial evidence. The strength of the inferences drawn from that evidence would not always be sufficient to meet the higher evidentiary standard. The use of a special standard in Commission penalty actions also would force the judge to apply simultaneously two different standards of proof to the same evidence -- the higher "clear and convincing" standard in determining the fact of violation for purposes of the penalty, and the lower "preponderance" standard in determining the fact of violation for purposes of injunctive relief if the penalty action and injunctive action were combined.

The Commission also opposes the addition of a jury trial provision. A statutory right to a jury trial could burden and prolong Commission actions for a penalty and complicate settlement negotiations. Moreover, the right to a jury trial in penalty actions may interfere with the successful prosecution of Commission injunctive proceedings. Potential problem areas include the effect of the doctrine of collateral estoppel, the consolidation and order of proceedings, and the possibility of inconsistent judgments.

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(f) <u>Increase in the maximum criminal fine for violations of the Securities Exchange Act</u>

The proposed legislation would raise the maximum criminal fine for most violations of the Exchange Act from $10,000 to $100,000. 7/ The increased criminal fines would not be limited to cases involving insider trading.

The maximum $10,000 criminal fine provided in the Exchange Act has not been changed since it was enacted nearly fifty years ago. In the intervening period, inflation has been nearly 700%. Thus, the passage of time has significantly eroded the deterrent effect of a $10,000 fine. By raising the maximum to $100,000, the bill will counter the effect of inflation, and enhance the potential deterrent effect of criminal fines.

An increase in the maximum criminal fine will emphasize the importance of deterring securities law violators, assure the availability of remedies that will have a greater deterrent effect, and thereby prevent future violations of the law. In addition, larger fines will benefit the public by allowing the federal government to recoup a greater portion of the cost of detecting and prosecuting securities law violators.

7/ The only violations exempt from this increase are violations of Section 30A of the Exchange Act (the Foreign Corrupt Practices provisions). These latter violations are treated separately by Section 32 of the Exchange Act and provide for maximum criminal fines of $1,000,000 for issuers, and up to $10,000 for individuals.

(g) Addition to Section 15(c)(4) of violations of Section 14

The House bill adds Section 14 of the Exchange Act to the sections under which an administrative proceeding under Section 15(c)(4) of that Act can be brought. Currently the Commission is authorized to bring an administrative proceeding under Section 15(c)(4) to require compliance with the requirements of Sections 12, 13 and 15(d) of the Exchange Act. For example, the Commission's 15(c)(4) order may require any person subject to the reporting requirements of those sections to correct deficient or misleading filings. With the addition of Section 14, the Commission would be able to bring an administrative proceeding to require compliance with the filing and other proxy and tender offer requirements of Section 14.

The Commission recently sent to Congress a review of the adequacy of the Commission's enforcement sanctions and remedies. The Commission reaffirmed its support for expansion of its authority to bring administrative proceedings under Section 15(c)(4) to encompass violations of Section 14 and the rules promulgated thereunder. In addition, the Commission also recommended a further amendment to clarify its authority to name as respondents, in proceedings instituted under Section 15(c)(4), individuals who cause failures to comply with Sections 12, 13, 14 or 15(d) of the Exchange Act, or of the rules promulgated thereunder.

VI. Conclusion

There is a great need for the additional deterrent measures to the securities laws that are contained in the Insider Trading Sanctions Act. The Commission supports the amended version of the bill passed by the House.

PRESENT STATE OF THE LAW

Senator D'AMATO. Thank you very much, Mr. Chairman.

Let me pose a problem to you as I see it and it's a very disturbing one. Let's look at the present state of the law with respect to insider trading. In the *Chiarella* case, you had a financial printer who uncovered the name of a target of a tender offer and he purchased the stock prior to the tender offer. Even though he devised the scheme to crack the code and then profited from the information, the Supreme Court said that he wasn't guilty under our present law.

The Court reasoned that *Chiarella* was not a so-called insider within the meaning of rule 10b-5 and since he owed no duty to the shareholders he was exempt from that provision of the law.

Now in light of that, don't you see a glaring loophole? Here is a person who comes in and cracks the code, who takes this information, who profits by this information. Isn't there a need to proscribe this conduct?

Mr. SHAD. The Commission believes that we could sustain such an action today, but I'd like the General Counsel to comment. In fact, there's some helpful language in the *Chiarella* case, notwithstanding the bottom line in the case—some helpful language relating to the misappropriation theory which has been upheld in subsequent cases.

Mr. Goelzer, would you like to comment?

Mr. GOELZER. I think John Fedders may also have some comments about these issues since he's responsible for actually bringing the enforcement actions in this area, but just concerning *Chiarella* generally, let me say this. I think the reason that the Supreme Court overturned Mr. Chiarella's criminal conviction was that the theory that had been presented in the charge to the jury in this case was not sustainable. It was one based on equal access to information. The misappropriation theory was not presented to the jury in the *Chiarella* case.

We believe, therefore, and we've brought a number of cases since *Chiarella* based on this proposition, that misappropriation of inside information is illegal under existing law. We have a case right now before the second circuit which is almost identical to *Chiarella*.

Senator D'AMATO. Well, the fact is that the Supreme Court has not reversed itself in that particular case, have they? It's still the law.

Mr. GOELZER. They have not. However, they have——

Senator D'AMATO. You have taken the case up to the second circuit and what you're saying is you hope that maybe they will come out with a new ruling on it.

Mr. GOELZER. Well, the Supreme Court did deny certiorari in a case called *Newman* subsequent to *Chiarella* in which the Government had charged the jury and prosecuted the case on the misappropriation theory that the concurring and dissenting opinions in *Chiarella* suggest it might be OK.

Senator D'AMATO. Mr. Fedders, you understand this Senator's concern? The concern is that if you're going to simply permit a narrow definition of insiders, then everything that takes place thereafter will be legal, people finding information or being given

information from someone who breaches a duty. To have a situation resulting like *Chiarella,* will cause people to be hurt. There are people who are losing profits. There is money that's being taken away from someone, as you testified.

Mr. FEDDERS. I think we effectively plead the misappropriation theory that Chairman Shad and Dan Goelzer talked about. As Dan has said, the Supreme Court, although holding that Mr. Chiarella was innocent of the charges brought against him, said the defect was one in pleading. It was not a case initiated by the Commission. It was a case initiated by the criminal prosecutor.

In a concurring opinion, Justice Stevens and Chief Justice Burger in his dissent, gave creditability to the misappropriation theory and the so-called conversion theory. The Commission has effectively used that theory since then, and criminal prosecutors have used it effectively in the case of *United States* v. *Newman.*

Now this theory is that an employee who misappropriates information from his employer that is subsequently used to profit in stock trading is guilty of securities fraud.

There's both good news and bad news. The good news is that the lower Federal courts seem to agree with the theory. The bad news is that the Supreme Court of the United States has rejected certiorari in the *Newman* case. The conviction of Newman does stand. Until the Supreme Court confirms the misappropriation theory, there's always some concern on our part in pleading cases using the misappropriation theory.

So I share the reluctance you have. So does the Chairman and so does Mr. Goelzer. But yet, at the present time, when we plead the misappropriation theory we are bringing to these specific pleadings intellectual meticulousness under the Chief Justice's dissent and Justice Stevens' concurring opinion, I think we are on viable and solid ground.

Senator D'AMATO. Let me ask you this. Would you describe the strengths and the weaknesses of the current law in layman's terms so the people can understand why we are at these crossroads in attempting to define the conduct that we find abhorrent and prompted this legislative hearing?

Mr. SHAD. Do you want me to start on that one? That's a very big question.

Senator D'AMATO. Whether you or Mr. Fedders would like to make an analytical comment.

WEAKNESSES OF THE PRESENT LAW

Mr. SHAD. I could comment and then he could amplify.

In terms of the weaknesses of the present law, I would say our concerns are that the long-term trend of the courts has been to steadily refine the definition and in doing so in some respects to narrow the application of the provisions of the securities laws that enable us to bring these cases. The most recent case is *Dirks,* where the Supreme Court introduced another refinement, if you will, in the law requiring that we be able to prove that the tipper had a direct or indirect benefit from making the information available to others who traded.

Each time that these cases have come up, the Supreme Court has tended to narrow the definition, but, the other side of the coin is that if we go to an entirely new definition, as proposed under the alternative to be discussed today, the problem that some are concerned about is that all of these new words and terms will have to be relitigated. Instead of bringing an increased certainty you're going to have perhaps a decade of new litigation because of such a dramatic change in the law itself. I would ask Mr. Goelzer to amplify on the weaknesses of the present law.

Mr. GOELZER. Well, I think you and John Fedders have given a good summary. Probably the main weakness is the fact that, as all of you have said, we don't know whether the Supreme Court will definitely sustain the misappropriation theory. We have had good luck with it in the lower courts since the *Chiarella* case, but the Supreme Court hasn't considered it.

I'd say that the other principal defect is the fact that at least one court of appeals has held that, in the misappropriation context, the injured investors have no private right of action to recover. That's the *Moss* case. I think that is a change in existing law that resulted from *Chiarella* and that is not favorable to those affected by insider trading.

Senator D'AMATO. Well, let me ask you simply, the rationale behind the misappropriation theory is that someone has converted and misused information, isn't this theory akin to the draft legislation before you that is based on use proscribing the unfair use of nonpublic information?

In light of that fact, wouldn't this bill supplement rule 10b–5?

Mr. SHAD. Yes; it could.

Senator D'AMATO. Wouldn't that be an additional strength in spelling out clearly the kind of conduct we wish to proscribe?

Mr. SHAD. My understanding is that the latest version of the proposal would fully incorporate rule 10b–5 so that all the actions and rights that the Commission has to suppress this activity under rule 10b–5 would be preserved. In addition, for purposes of this penalty, which obviously is a dramatic escalation of the costs of violating the law, there would be specific categories of individuals who could be charged, and the Commission would not have to prove fraud. It would suffice that if an officer or director of a corporation who is in possession of inside information purchased securities and made a profit, he would be subject to the penalty.

In my view—although the full Commission again hasn't formally considered it—in my view, such a proposal would add specificity and simplicity subject to the necessity to relitigate all of these new provisions over a period of years.

Senator D'AMATO. Mr. Fedders, would you care to elaborate on this? As I suggested, doesn't the proposed legislation supplement rule 10b–5 and make it easier for the Commission or the Justice Department to go after those people who are taking advantage of this information?

Mr. FEDDERS. I think you're correct, Senator. Whether it makes it easier or not, I don't know. In anticipation of this hearing, I have very carefully considered the pros and cons of the definition and I have prepared, if you want me to do it here or I can provide it to

you by letter, six very compelling reasons for a definition and six very compelling reasons against a definition.

Senator D'AMATO. You should truly seek public office.

Mr. FEDDERS. No, thank you. I have had enough sunshine in 2½ years.

At the same time, I have these six pros and cons and I will provide them either in this testimony or by letter.

Senator D'AMATO. I think it's important if you touch on them briefly.

SIX REASONS FOR A DEFINITION

Mr. FEDDERS. First, when considering a definition, it depends on how you approach it. There could be a codification of existing insider trading case law under section 10b of the 1934 act. That's one way. A second way would be an attempt to narrow or to broaden existing case law in the context of section 10b. The third way would be the approach you refer to as the Milton Freeman approach, which is to supplement rule 10b-5 and the antifraud provisions of the Federal securities laws.

Let me tell you what I think the six reasons are supporting a definition of insider trading.

First, Congress is our lawmaker. It has not taken the opportunity to define insider trading. This misconduct is generally prosecuted under the antifraud provisions of the 1934 act. Consideration of the Insider Trading Sanctions Act gives Congress an opportunity to establish the law prohibiting this course of misconduct.

Second, by defining insider trading, Congress would establish the parameters of the illegal conduct: namely, (a) whether an information parity law is desirable, (b) whether it agrees with the Supreme Court's application of the antifraud provisions in the *Chiarella* and *Dirks* decision, and (c) to address a host of other complex issues decided by the Federal district and appellate courts relating to trading while in possession of material nonpublic information about an issuer or the trading market for an issuer's securities by insiders, tippees, and remote tippees. The definition would permit Congress to prohibit the conduct it wants to make illegal.

Third, and I think this is the most compelling reason in favor of a definition, a definition would permit Congress to clarify the law for the benefit of the investing public as well as the Commission and criminal prosecutors. Justice Holmes has said that the tendency of the law must always be to narrow the field of uncertainty. Commentators have said that uncertainty remains in the law of insider trading, particularly the law relating to conduct by tippees. In my view, justice is too important to be left solely to judges and lawyers acting on a case-by-case ad hoc basis. Congress is our lawmaker. Clarification of the law by Congress would permit investors to chart their course of conduct confident in their obligations.

Fourth, the current state of the insider trading case law places an enormous burden on the Commission as prosecutor to determine whether a particular course of tipping or trading conduct is illegal. Insider trading by insiders and tippees, as I said, is prosecuted under the antifraud provisions, and the courts have developed a number of complex theories which must be met by the Commission and criminal prosecutors. For example, when initiating an insider trading case we must consider such diverse theories as (a) breach of duty, (b) misappropriation or conversion of information, (c) con-

structive or temporary insiders, and (d) communication of information for personal pecuniary or reputational gain or to confer a gift of trading information. These legal theories make application of law to facts difficult. These legal theories developed by the courts do not necessarily have anything to do with the harm to the public caused by conduct of insider trading.

Now I'm not criticizing the courts. They have a difficult task applying the general antifraud provisions to this wrongful conduct. As a result of the development of these complex legal theories, the Commission has had to allege in its insider trading complaints facts concerning the relationships of the parties which have little direct bearing on the act of insider trading by insiders or tippees. But the expansive allegations were necessary to meet the legal test established by the courts.

If Congress defines this prohibited course of conduct, it could make it easier on law enforcers to investigate and plead their cases without such theories as (a) duty, (b) misappropriation, (c) conferring a benefit, et cetera.

A fifth reason supporting a definition would be it is difficult to argue against any insider trading legislative proposal which would supplement the Commission's enforcement tools to prosecute insider trading and their tippees. I refer to the proposal that you have called the Freeman proposal. My understanding is that this new law would not infringe upon the Commission's ability to prosecute insider traders under the antifraud provisions or rule 14e–3.

Sixth, some have also argued that if Congress adds the triple civil money penalty for violation of the insider trading law, investors deserve greater clarity of the prohibited conduct.

Having given six advantages to be a good politician, I have six disadvantages as well.

SIX REASONS FOR NOT DEFINING PRESENT LAW FURTHER

My greatest fear—and I wouldn't want to minimize this a bit—is that Congress will turn its attention to a definition of insider trading and it will further delay the enactment of this important piece of legislation. Indeed, I fear it may kill the legislation.

The integrity of our markets requires this law to deter potential wrongdoers from this course of misconduct.

The second is a very important reason which was acknowledged by the House of Representatives. It is the House view that the law prohibiting insider trading has been sufficiently well developed by the courts to provide adequate guidance. They, and many commentators, are of the view that there are not great ambiguities in the law of insider trading. Their view is that the law works well and that the courts have properly restrained the Commission when it applies the antifraud provisions to courses of conduct which are not fraudulent and do not jeopardize the integrity of our markets.

Third, there is the legitimate concern that a definition with new terms and its legislative history would create new ambiguities, thereby increasing rather than limiting uncertainty. This will mean a decade of vigorous and expensive litigation over the new terms used by Congress. This concerns me. I am resource-oriented and believe that we have to have a cost-benefit analysis when we

consider this kind of undertaking. I am hopeful that, if Congress insists upon a definition, it will give great deference to the Commission and its views on what the definition should include.

Fourth, a definition of insider trading for purposes of enforcement actions under rule 10b-5 may reduce the Commission's flexibility to prosecute evolving types of misconduct. Who would have thought in 1934 about some of the kinds of insider trading that are being perpetrated on the public today? And any definition that ruins our flexibility is going to be a substantial burden on the Commission protecting the integrity of our markets. Maintaining flexibility rather than being locked into a definition that might prove too rigid to address currently unperceived abuses that might develop is desirable.

Fifth, a poorly drafted definition may unduly restrict brokerage firms in block trading, arbitrage, and other types of legitimate brokerage activity. Any carveouts in the definition for such activities would inevitably make legal some conduct Congress wants to prohibit.

Sixth and finally, drafting a comprehensive definition is enormously difficult. My colleague, Dan Goelzer, has said it is the greatest cottage industry in Washington, D.C., at the present time. The Commission staff can attest to this. Dan, myself, and our colleagues have been at the task for 5 months, and we haven't reached agreement. It is impossible to figure out all the alternatives and millions of permutations and combinations. All these cannot be addressed in a definition. This is why the antifraud provisions work so well. They provide the Commission the flexibility on a case-by-case basis.

I'm sorry to have taken so much of your time, but I think each of the six pros and cons are worthy of your consideration.

Senator D'AMATO. In recent weeks, we've had much attention on the SEC's inquiry with respect to CBS and the story that came out on Nutrisweet and the events surrounding that as well as the events of the reporter from the Wall Street Journal.

Under the present law, what theory do you proceed in terms of this action? I'm not asking you to get into the details.

Mr. FEDDERS. Senator, I think it would be inappropriate for me to even confirm the existence of a Commission investigation with regard to any of the matters to which you referred. I would answer only by saying that our surveillance of the market is more comprehensive than it has ever been. The insider trading program is something that is receiving 8 percent of our resources, both in fiscal years, 1982 and 1983, and in the present fiscal year.

If the words over the door of the Supreme Court mean anything, "Equal Justice Under Law," to begin to take specific fact circumstances and discuss them at this time, if I did that, I'm not worthy of holding this job. We will be vigorous and we will do anything, even on circumstantial evidence, to prosecute people who jeopardize the integrity of our markets.

Senator D'AMATO. Well, obviously you feel that you have sufficient tools under the present law to become involved in a case like this. Let me put it to you this way. If you had the definition before you which supplements rule 10-5, would that make your case easier or more difficult?

Mr. FEDDERS. Senator, that's a very difficult question. I would address it this way, which is going to be intentionally evasive. I have not studied——

Senator D'AMATO. Well, if you were to apply my definition to these types of cases—let's put aside the CBS issue and the Wall Street Journal—but that kind of situation, what would that do? Would that give you additional tools and resources? Would it make your case more difficult?

Mr. FEDDERS. If the hypotheticals you talked about were prosecuted today, I would probably not prosecute them under the definition. I would use the expansive language of the antifraud provisions of the Federal securities laws.

I have studied this definition for the weekend, and I've thought about what you've said and the way you've asked the questions. I have six principal concerns with the definitions proposed. I am not pooh-poohing on the definition. The man who drafted it was my mentor and he was my former partner. I have great respect for him, but, notwithstanding that, I have to bring my own independence to this.

DEFINITION AS DRAFTED MAY BE DEFENSE LAWYER'S MECCA

First, the definition as drafted may be a defense lawyer's mecca. It is filled with ambiguities which are correctible, but I don't want any definition that will provoke years of litigation. Every time the Commission has to litigate, it uses valuable resources.

Second, I'm not sure that the definition is sufficiently broad to cover certain illegal insider trading acts to which the treble penalty should apply. It addresses a narrower category of unlawful conduct than H.R. 559.

Third, if we're going to go to a definition, let's abandon some of these complex theories that the Supreme Court has given us in *Dirks* such as duty. Consequently, there is no real benefit of clarity of law to investors and the Commission.

Fourth, addressing tippee cases, as I read the definition, the tippee liability has been narrowed from that under rule 10b–5.

A fifth concern relates to the so-called safe harbor or Chinese wall tests. The attempt to recite what is presently embodied in rule 14e–3 are phrased in the disjunctive and, consequently, do not provide a sufficient breadth of investigator protection.

The sixth concern is probably the one that troubles me the most, and that's proof. My concern is that the proof of tippee's knowledge of a tippee's breach of fiduciary duty appears in the proposed definition to be higher than the scienter requirement in section 10(G).

Now section 10(G) presently includes recklessness, and I'm not so sure that the definition permits us to use recklessness as a proof standard.

So those are six concerns after a weekend of work, but at the same time, I think you can tell by the way I have the pros and the cons that I do think there are some benefits of a definition. I don't want to give the impression that I'm simply throwing the definition out. My job is to make sure that I have a tool that I can effectively prosecute with and I'm going to be free—doing it respectfully—to criticize it, only to improve it, not to kill it.

Senator D'AMATO. Senator Proxmire.

Senator PROXMIRE. Thank you very much, Mr. Chairman.

Mr. Shad, you obviously recognize insider trading as a serious, serious problem and you indicated it will be a more serious problem as time goes on due to mergers and so forth and I think Mr. Fedders called those who engage in insider trading thieves. Yet I'm wondering about the severity of the recommendations that you make to us here and whether or not the bill that comes from the House is really strong enough.

First, this is an evil that's been going on for a long, long time and I notice on page 3 of your statement, Mr. Shad, you indicate that there's been—using the arithmetic that you give us—that there's been about 140 cases brought against people who have been involved in insider trading.

Mr. SHAD. Yes.

Senator PROXMIRE. Mr. Fedders, as the head of the Enforcement Division, how many successful criminal prosecutions for insider trading have there been in the 50 years the SEC has been in operation?

Mr. FEDDERS. Less than 10, Senator.

Senator PROXMIRE. When was the last successful prosecution that required a fine or penalty?

Mr. FEDDERS. Certainly within the last 2½ years. I can't be specific. I have a couple cases in mind, but I can't be specific when the last one was. Certainly in the last 2½ years.

Senator PROXMIRE. Here you have a situation, as you say, where those who engage in insider trading are thieves and yet the chances of being prosecuted and penalized seem very, very slim—approximately 1 in 14, according to your own figures—and if you are prosecuted and convicted, you don't go to the slammer. The severest penalty is that you pay a fine of some kind.

Mr. FEDDERS. Let me explain to you what I consider to be the rationale for that if I could.

Senator PROXMIRE. Yes.

Mr. FEDDERS. In my view, no insider trading case has been prosecuted using direct, uncontroverted evidence. It's probably better to say it the other way. All insider trading cases are prosecuted on circumstantial evidence. No one leaves a paper trail saying that he's engaged in insider trading. We put these cases together by putting material nonpublic information in someone's possession and then you deal with phone conversations of one person to another. Those are all evidentiary problems that we have based on circumstantial evidence.

Now the burden of proof the Commission must meet is the preponderance of the evidence, and the Supreme Court has said in the *Herman MacLean* case in footnote 30, that circumstantial evidence is adequate to meet a preponderance of evidence test.

DIFFICULTY OF USING CIRCUMSTANTIAL EVIDENCE

Now when you go into the criminal forum you meet the burden of proof beyond a reasonable doubt, and to take circumstantial evidence and meet that burden is difficult for criminal prosecutors. That's why I think Chairman Shad's initiative with the civil penal-

ty is correct. We know that it's going to continue to be circumstantial evidence that we act on. We're going to meet the preponderance of evidence test. We're not only going to require disgorgement of ill-gained profits but—because of his, and your, and other Senators, and House initiatives—we're going to have the treble money penalty. But meeting the test of beyond a reasonable doubt in a criminal court is difficult.

Senator PROXMIRE. Let me just go back a little bit. Over the last 50 years there have been about three cases brought a year and about once every 5 years on the average, somebody has to pay some kind of a fine or some kind of financial penalty.

How many have been referred to the Department of Justice for prosecution?

Mr. FEDDERS. I can't give you a specific number, but I can tell you this——

Senator PROXMIRE. Will you give us the number that have been prosecuted for the record and indicate briefly a summary of each one, and the number in which a penalty has been paid?

Mr. FEDDERS. I think that number is readily available. I would say in the past couple years insider trading has become so prominent that there's not an insider trading case we filed where there is not an inquiry from a criminal prosecutor as to whether or not we believe that it might meet the beyond a reasonable doubt burden. None of them are neglected.

Senator PROXMIRE. Except wouldn't you agree that in view of the temptation for people who are insiders to trade on inside information that there have probably been close to several hundred or maybe several thousand infractions a year, but only about three a year have been prosecuted and only a tiny, tiny fraction of those have resulted in any kind of penalty, and there's never been a jail penalty.

Mr. FEDDERS. There could be a jail penalty under the criminal prosecution.

Senator PROXMIRE. Well, there never has been anybody who has gone to jail.

Mr. FEDDERS. To my knowledge, that's correct.

[The following information was subsequently submitted for the record:]

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

IVISION OF
NFORCEMENT

June 1, 1984

OP 4-1

The Honorable Alfonse M. D'Amato
Chairman
Subcommittee on Securities
Committee on Banking, Housing and
Urban Affairs
United States Senate
Washington, D. C. 20510

The Honorable William Proxmire
Subcommittee on Securities
Committee on Banking, Housing and
Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Senators D'Amato and Proxmire:

During a hearing on April 4, 1984 before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, concerning S. 910, the Insider Trading Sanctions Act, Senator Proxmire requested that I supply the Subcommittee with information regarding criminal prosecutions of insider trading cases and Commission referrals of its insider trading investigations to the Department of Justice.

Most of the Commission's investigations relating to insider trading have resulted in informal discussions between members of the Commission's staff and either the staff of the Department of Justice or one or more U.S. Attorneys' offices. In addition to the informal discussions, more than 40% of the insider trading cases brought by the Commission from October 1, 1980 to date have resulted in a formal referral <u>or</u> grant of access to Commission files to the Department of Justice or one of the U.S. Attorneys' offices.

Of the 61 insider trading cases brought by the Commission since the beginning of fiscal year 1981, 7 cases were formally referred to the Department of Justice and 19 were the subject of access grants. During this time period, the staff also has granted access to its files on five occasions concerning insider trading investigations which have <u>not</u> yet resulted in a Commission enforcement action.

The Honorable Alfonse M. D'Amato
The Honorable William Proxmire
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The enclosed listing of criminal prosecutions by the Department of Justice represents all of the criminal actions relating to insider trading violations of which the Commission staff is aware which have been instituted since the beginning of fiscal 1981. Twenty-two such cases are listed, including three which charged obstruction of justice for impeding a Commission investigation. In 17 cases sentence has been imposed. Five defendants have been sentenced to terms of imprisonment (ranging from 39 consecutive weekends to one year and one day), 8 have been ordered to perform a specified number of hours of community service, and 11 were placed on several years probation (from 2-1/2 years to 5 years). Four defendants were fined $5,000, and 11 were fined $10,000.

The Commission often seeks disgorgement of illgotten gains as ancillary relief in its civil injunctive actions. Such relief is not punitive, but serves to deprive violators of the benefits of their illegal acts. The Commission has obtained disgorgement orders in most of its recent insider trading cases; in fiscal 1982 and 1983 combined, over $5.5 million was ordered as disgorgement in insider trading cases.

I hope this information will be of assistance to the Subcommittee as it considers S. 910. If the Subcommittee has any other questions regarding the prosecution of those who have been involved in insider trading, or the Insider Trading Sanctions Act, please do not hesitate to contact me at 272-2900.

Very truly yours,

John M. Fedders

John M. Fedders
Director

Enclosure

cc: Chairman John S.R. Shad
Commissioner James C. Treadway, Jr.
Commissioner Charles C. Cox
Commissioner Charles L. Marinaccio

May 1984

Criminal Insider Trading Cases 1/

1. United States v. Carl R. Snodgrass, 83 Cr. 134 (WDVa 1984)

Snodgrass, former President, Chief Executive Officer and Director of the First State Bank of Wise, pled guilty on April 24, 1984 to 16 counts in a 17 count indictment which charged him with, among other things, failure to file required currency transaction reports with the IRS, misapplication of bank funds, and insider trading (one count of failure to file currency reports was dropped). The insider trading charge alleged that Snodgrass purchased shares of First State Bank of Wise while negotiating for the acquisition of that bank by another bank, and prior to public announcement of the acquisition.

Snodgrass is presently awaiting sentencing.

2. United States v. James Covello, 84 Cr. 204 (SDNY 1984)

James Covello pled guilty to a two count information which charged him with conspiracy and violation of the anti-fraud provisions of the federal securities laws. Covello was one of a group of persons charged with obtaining material non-public information concerning tender offers, leveraged buyouts and acquisitions from an employee of a New York law firm, and illegally trading while in possession of that information.

Covello is awaiting sentencing.

3. United States v. Steven M. Crow, 84 Cr. 239 (SDNY 1984)

Steven Crow, formerly a word processor at Skadden Arps Slate Meagher & Flom, pled guilty to a two count information which charged him with conspiracy to violate Sections 10(b) and 14(e) of the Exchange Act, and with violating the mail fraud statute.

Specifically, the information charged that Crow conspired with others, including another employee of Skadden Arps and two registered representatives of brokerage firms, to trade in securities while in possession of material non-public information. According to the information,

1/ Not included in this list are U.S. v. Green 83 Cr. 134 (WDVa 1984), in which the government entered a motion nolle prosequi and U.S. v. Chiarella, 445 U.S. 222 (1980), where the Supreme Court overturned the conviction.

Crow misappropriated confidential non-public information concerning proposed acquisitions and takeovers planned by clients of Skadden Arps. Crow obtained this information by electronically searching various confidential and coded computer files of the firm. Thereafter, Crow passed this information to a fellow employee who in turn passed the information to other co-conspirators in exchange for money and other things of value.

Crow is awaiting sentencing, and faces a maximum penalty of ten years imprisonment and $11,000 in fines.

4. United States v. Salvatore 84 Cr. 260 (SDNY 1984)

Alfred Salvatore, a former proofreader for the New York law firm of Skadden Arps Slate Meagher & Flom, pled guilty to a charge of conspiracy to commit securities fraud, as well as separate charges relating to securities fraud and mail fraud. Salvatore admitted to misappropriating material non-public information about proposed tender offers, mergers and other acquisitions and takeovers planned by the law firm's clients.

Sentencing is scheduled for June 1984.

5. United States v. James Pondiccio, Jr., 84 Cr. 009 (SDNY 1984)

James V. Pondiccio, Jr., former assistant head trader at Lazard Freres & Co., pled guilty to a criminal information charging him with violation of the mail fraud statute. The information charged that Pondiccio traded on inside information in connection with the tender offer by Joseph E. Seagram & Sons, Inc. for St. Joe Minerals Corporation in March 1981.

The Information charged that Pondiccio through his position at Lazard learned that Lazard was preparing a tender offer on Seagram's behalf for the stock of St. Joe Minerals. Pondiccio and other Lazard and Seagram employees privy to information concerning the proposed tender offer were under strict instructions not to trade in St. Joe stock or to tip off anyone else.

Shortly before the tender offer was announced, according to the Information, Pondiccio purchased options on St. Joe stock, trading through the accounts of members of his family at another brokerage firm in order to keep his activities secret from Lazard and law enforcement authorities. The price of St. Joe stock rose sharply when the tender offer was announced, enabling Pondiccio to make a profit of some $40,000 in a matter of days.

On March 9, 1984 Pondiccio was sentenced to 5 years probation and ordered to serve 200 hours of community service.

6. United States v. Thomas A. Peacock, 83 Cr. 275 (DDC 1983)

Thomas A. Peacock pled guilty to a one count information charging him with obstruction of justice in connection with an investigation conducted by the Commission to determine whether certain persons purchased securities of Santa Fe International Corporation while in possession of material nonpublic information concerning a merger between Santa Fe and Kuwait Petroleum Corporation. During the relevant period of time Peacock served as Vice President for Government and Public Affairs of International Coal Refining Co., a subsidiary of Wheelabrator-Frye, Inc.

The information charged that Peacock obstructed and impeded the Commission's investigation by preparing and giving false and misleading statements to the Commission concerning the true source and nature of the information Peacock received which led to the purchase of Santa Fe options.

Peacock was sentenced to two years' probation, fined $5,000 and ordered to perform 200 hours of community service.

7. United States v. Tatusko, 83 Cr. 230 (DDC 1983)

On September 30, 1983, Stephen Tatusko pled guilty to a one count information charging him with obstruction of justice in connection with an investigation conducted by the Commission to determine whether certain persons purchased securities of Santa Fe International Corporation while in possession of material non-public information concerning a merger between Santa Fe and Kuwait Petroleum Corporation. During the relevant time period Tatusko was a registered representative associated with Bellamah, Neuhauser and Barrett, Inc., a broker-dealer located in Washington, D.C.

The information charged that Tatusko obstructed and impeded the Commission's investigation by preparing and giving false and misleading statements and information to officers of the Commission for the purpose of concealing and causing to be concealed from the Commmission the true source and nature of the information Tatusko received which led to the purchase of Santa Fe options by Tatusko and others at Bellamah.

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The Court imposed a fine of $5,000, ordered Tatusko to contribute 300 hours of community service and sentenced him to three years probation.

8. United States v. Rubinstein, 83 Cr. 474 (SDNY 1983)

Kenneth Rubinstein, an attorney formerly associated with a New York City law firm, pled guilty to a two count information charging him with violations of the federal securities laws. The information charged that Rubinstein, while in possession of material non-public nformation obtained while working as an attorney of the law firm, traded in the securities of Brookwood Health Services Inc., Texasgulf, Inc., Midwestern Fidelity Corporation and Cenco Inc. accumulating in nominee accounts profits totalling $175,000.

Mr. Rubenstein was sentenced on September 23, 1983 to 2-1/2 years probation.

9. United States v. Cooper, 83 Cr. 616 (CDCal 1983)

A one count information filed against Cooper, an assistant vice president at Bankers Trust, charged him with violation Rule 14e-3 of the Exchange Act, which prohibits trading wh le in possession of material non-public information concerning a tender offer once a substantial step to commence the offer has been made. The information alleged that Cooper, acting in his capacities as an officer and employee of Bankers Trust and banker for Whittaker Corporation obtained certain information from employees and officers of Wh ttaker concerning Wh ttaker's plans to make a tender offer for Brunsw ck Corporation The information charged that Cooper wrongfully used and misappropriated this information by purchasing Brunswick stock and options.

Cooper pled guilty to the information charging him with violating Rule 14e-3 and was fined $10,000.

10. United States v. Hutchinson, 83 Cr. _____ (DDC)

The defendant pled guilty to a one count information charging him with a violation of Rule 14e-3. The information alleged that Whittaker Corporation had taken substantial steps to commence a tender offer for the securities of Brunswick Corporation, and that the defendant came into possession of material information relating to the tender offer which he knew or should have had reason to know was nonpublic and which he knew or should have had reason to know had been acquired from Whittaker.

According to the information, Hutchinson communicated the material nonpublic information relating to the tender offer to a friend under circumstances in which it was reasonably foreseeable that such communication was likely to result in that person's purchase of Brunswick securities on the basis of such information.

The court imposed a fine of $10,000 on Hutchinson.

11. United States v. Chadwick, 83 Cr. 615 (CDCal 1983)

A one count information was filed against Chadwick which alleged a violation of Rule 14e-3. The information alleged that Chadwick knew that Martin Cooper ("Cooper") was an employee of Bankers Trust and that Cooper handled the Whittaker Corporation account for Bankers Trust. The information further alleged that Cooper acting in his capacities as an officer and employee of Bankers Trust, obtained from employees and officers of Whittaker certain material information concerning Whittaker's plans to commence a tender offer to acquire stock of Brunswick. The information further alleged that Cooper wrongfully used and misappropriated the information by purchasing Brunswick stock and Brunswick options, and also supplied this information to Chadwick, who purchased Brunswick options while in possession of this information and recommended such purchases to others. Chadwick pled guilty to the one count information.

The court imposed a fine of $10,000 on Chadwick.

12. United States v. Fabregas, 83 Cr. 614 (CDCal 1983)

The defendant pled guilty to a single count information charging him with violating Rule 14e-3. The information alleged that Fabregas, a vice president and loan officer of Credit Suisse, acting in his official capacities, obtained information concerning Whittaker Corporation's plans to make a tender offer to acquire the stock of Brunswick Corporation. The information alleged that Fabregas wrongfully used and misappropriated the information by purchasing Brunswick options and disclosing this information to his broker.

Following the acceptance of Fabregas' guilty plea, the court imposed a fine of $10,000.

13. United States v. Nugent, 83 Cr. _____ (DDC 1983)

On May 24, 1983, Nugent pled guilty to a one count information charging him with aiding and abetting violations of Rule 10b-5 promulgated under Section 10(b) of the Exchange Act in connection with the purchase of call options for the common stock of Santa Fe International Corp.

Nugent, a former officer of Timmons & Co., a of Washington, D.C., learned of the impending merger between Santa Fe and Kuwait Petroleum Corp. Nugent informed a friend and associate of the planned merger, who in turn purchased 200 call options for Santa Fe common stock. Nugent's friend subsequently realized profits of nearly $250,000 in a five day period. Nugent received $500 of these funds.

Following the entry of the guilty plea, Nugent was fined $10,000 and ordered to contribute 300 hours of community service. The court determined that Nugent did not have knowledge of the provision proscribing the conduct in which he engaged. As such, Section 32(a) of the Exchange Act exempted Nugent from being subject to imprisonment.

14. United States v. Constantine Spyropoulos, 82 Cr. 116 (SDNY 1983)

On January 31, 1983, Constantine Spyropoulos pled guilty to conspiring to violate the securities and mail fraud laws by trading in 17 stocks based on material nonpublic information concerning unannounced corporate takeovers, stolen from Morgan Stanley & Co. and Kuhn Loeb & Co. Spyropoulos admitted in his plea that he conspired with two former investment bankers, who had been employees of Morgan Stanley and Kuhn Loeb, to profit on confidential information those bankers received as trusted employees of Morgan Stanley and Kuhn Loeb.

According to the indictment, Spyropoulos and his co-conspirators used the information to purchase the stocks of 17 target companies prior to the public announcements of confidential merger and takeover discussions. Spyropoulos used secret bank accounts in Switzerland to purchase the securities.

The indictment to which Spyropoulos pled guilty was filed in February of 1981. On May 18, 1981, the indictment was dismissed by the District Court, but on October 30, 1981, after the Government appealed, the Court of Appeals for the Second Circuit reinstated the indictment.

On March 30, 1983, Spyropoulos was sentenced to a $10,000 fine and three years' probation.

15. United States v. Nussbaum (SDNY 1983)

Nussbaum pled guilty to a one count information which charged that he conspired with others to trade in securities while in possession of material non-public information, concerning unannounced corporate takeovers, stolen from Morgan Stanley & Co. and Kuhn Loeb & Co.

Nussbaum was sentenced to five years probation and 350 hours of community service, and a fine of $10,000 was imposed.

16. United States v. Paul, 83 Cr. 14 (SDNY 1983)

An eleven count indictment charged Bruce Paul, a stockbroker, with five counts of perjury in connection with an SEC deposition, five counts of making false statements to federal officers, and one count of obstruction of an SEC proceeding. According to the indictment, the perjury and false statement charges result from false statements made by Paul to the SEC staff during an investigation concerning trading on material non-public information.

On March 16, 1983, Paul pled guilty to two counts of filing false tax returns after two days of trial. The charges to which Paul pled guilty resulted from false statements made by him in his personal tax returns for 1977 and 1978 which failed to reveal income from securities trading and dividend income received during those years. Paul admitted that he opened, controlled and received profits from nominee stock brokerage accounts in the names of his relatives. Paul admitted that he did not report the profits from those accounts on his federal tax returns.

On May 4, 1983, Paul was sentenced to a $10,000 fine, 250 hours of community service and three years probation.

17. United States v. Howard L. Davidowitz, 82 Cr. 846 (SDNY 1982)

On December 22, 1982, Howard L. Davidowitz pled guilty to an information charging him with violations of the anti-fraud provisions of the Exchange Act and the mail fraud statute in connection with transactions in the securities of Drug Fair, Inc. According to the Information, Davidowitz was National Director for Retail Consulting Services for Ernst & Whinney, a public accounting firm, when Gray Drug Stores Inc. retained Ernst & Whinney for the purpose of assisting in the assessment of the feasibility of plans for a merger or takeover of Drug Fair, Inc. The information alleged that Davidowitz purchased 11,000 shares of Drug Fair securities; following the public announcement of the proposed acquisition, Davidowitz sold the securities realizing a profit of $45,746.37.

On February 2, 1983, Davidowitz was sentenced to a term of imprisonment of 39 consecutive weekends, a fine of $10,000 and five years of probation, including one year of public service.

18. United States v. Mark C. Saunders, 82 Cr. 157 (EDVa 1982)

An indictment charged Saunders with two counts of violating Section 208 of Title 18 of the United States Code in connection with his purchases of the common stock of Whitehall Corporation.

According to the indictment, Saunders, a civilian employee of the Department of the Navy, participated in the awarding of a $58 million Navy contract to a subsidiary of Whitehall Corporation. On January 18, 1981 and May 18, 1981, Saunders purchased 500 and 300 shares of the common stock of Whitehall Corporation. The indictment charged that Saunders knowingly and willfully participated as a government officer through decision, approval, recommendation and otherwise in regard to the Navy contract with an entity in which he had a financial interest.

On August 30, 1982, Saunders pled guilty to one count of violating Rule 10b-5. In October 1982, a fine of $5,000 was imposed on Saunders.

19. United States v. Carlo M. Florentino, 82 Cr. 450 (SDNY 1982)

An indictment charged Florentino with violations of the mail fraud statute and the antifraud provisions of the federal securities laws in connection with purchases of securities while in possession of material non-public information.

According to the indictment, Florentino, a lawyer, purchased securities of companies that were the subject of tender offers or involved in mergers. Law firms with which Mr. Florentino was associated represented participants in the tender offers and mergers. Florentino pled guilty to two counts of securities fraud.

On October 4, 1982, Florentino was sentenced to one year in prison and two year's probation. The prison sentence was suspended provided that Florentino disgorge more then $435,000 in profits that he realized by trading while in possession of material non-public information and comply with certain other conditions.

20. United States v. Newman, No. 81-1225 (2d Cir. Oct. 30, 1981), cert. denied, 52 U.S.L.W. 3266 (1983)

Two former employees of investment banking firms "tipped" their accomplices, including Newman, a trader and manager of the over-the-counter trading department of a New York brokerage firm, of impending mergers and tender offers by clients of their employers. These accomplices then purchased securities in the target companies and reaped substantial profits after the announcement of the merger or tender offer. The profits were then shared with the two "tippers."

On May 21, 1982, the Jury found Newman guilty of securities law, mail fraud and conspiracy violations. On July 16, 1982, Newman was sentenced to one year and one day in jail and the payment of a $10,000 fine. Newman was also sentenced to three years of probation conditioned upon his performance of voluntary unpaid community service.

In October 1983, the Supreme Court denied certiorari in this matter, 52 U.S.L.W. 3266 (1983).

21. United States v. Antoniu, 80 Cr. 742 (SDNY 1980)

Adrian Antoniu pled guilty on November 13, 1980, to a two-count information charging him with participating with four other defendants in a scheme to effect transactions in the securities of 17 companies on the basis of material, non-public information about impending takeovers of those companies.

On August 11, 1982 Antoniu was sentenced to three months incarceration, three years probation and a $5,000 fine for criminal violations of the antifraud provisions of the securities laws.

22. United States v. E. Jacques Courtois, Jr., 81 Cr. 53 (SDNY 1983)

On December 7, 1983, E. Jacques Courtois pled guilty to one count of criminal conspiracy and three counts of securities fraud.

Courtois, a Canadian national, was formerly a vice president in the Mergers and Acquisitions Department at the investment banking firm of Morgan Stanley & Co. He pled guilty to misappropriating confidential information about impending corporate takeovers and leaking it to confederates who purchased stock in the target companies.

As part of his plea agreement, Courtois was ordered to pay $150,000 into a fund to provide partial recompense to investors who sold their stock in the target companies to Courtois' co-conspirators. Courtois was sentenced to 6 months imprisonment and fined $10,000. 2/

2/ Franklin Carniol, also indicted for effecting illegal purchases, remains a fugitive in Belgium.

Senator PROXMIRE. Now Mr. Shad, let me direct this. There have been widespread reports that you oppose bringing injunctive enforcement actions against an issuer and that you have championed the notion that when the corporation is victim it may be desirable and in the interest of shareholders not to charge the corporation for violations caused in its name by officers, directors, or employees. In other words, you favor bringing action against individuals and you oppose bringing actions against corporations.

Commissioner Treadway——

Mr. SHAD. I think you——

Senator PROXMIRE. Let me finish my question.

Mr. SHAD. Well, it's misstated.

Senator PROXMIRE. According to Commissioner Treadway, and I'm quoting Mr. Treadway:

> The shift in emphasis you favor would subject the SEC and you personally, Mr. Shad, to much publicity and criticism and perhaps congressional inquiry. Many would contend that we are trying to rewrite the statute at the administrative agency level, and that we are soft on big business and the corporate world. In short, that we are trying to gut the enforcement program.

How many times have you voted against naming corporations in individual complaints?

Mr. SHAD. I would not think it's very often, but I couldn't give you an accurate count. The vast majority of Commission decisions in closed meetings are unanimous: in cases where I would have voted against naming the company, I'm sure the other Commissioners would have concurred. But I have to set the record straight——

Senator PROXMIRE. Before you do that, will you give us for the record the number of times you voted against naming corporations?

Mr. SHAD. Sure. I'll be glad to.

[The following information was subsequently submitted for the record:]

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF THE
GENERAL COUNSEL

June 4, 1984

Edward M. Malan
Senate Committee on Banking, Housing
and Urban Affairs
Room SD-534
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Malan:

Chairman Shad has asked me to respond to your request for information in response to a question asked by Senator Proxmire during the Commission's April 3, 1984 testimony on the Insider Trading Sanctions Act. Mr. Proxmire asked that Chairman Shad supply for the record the number of times he had voted against naming a corporation in an individual complaint.

We have identified 8 occasions, from the beginning of Chairman Shad's tenure with the Commission to April 3, 1984, on which Chairman Shad voted not to institute an injunctive action against a corporation. That figure includes both cases where there was a split among the votes of the Commissioners and cases where the Commission was unanimous.

Chairman Shad explained his position on this issue in a March 4, 1984 article in the New York Times. I have enclosed a copy of the article and request that it be included in the hearing record along with this letter.

If I can be of further assistance, do not hesitate to contact me.

Sincerely,

Daniel L. Goelzer

Daniel L. Goelzer
General Counsel

Enclosure

THE NEW YORK TIMES, SUNDAY, MARCH 4, 1984

Forum

CORPORATE PUNISHMENT

Who Pays for Executive Sins?

By JOHN S. R. SHAD

Drawings by David G. Klein

THE Securities and Exchange Commission is a collegial body in which issues and concepts are frequently discussed and debated. I have informally solicited the other commissioners' views as to whether the S.E.C. sometimes harms, rather than helps shareholders, by enjoining companies for the misdeeds of former employees. These include cases in which the former employees have absconded with corporate funds or falsified records to obtain promotions, bonuses or other personal benefits at their companies' expense.

Although even raising the question has been viewed with alarm in some quarters, surely investors and most others agree that such individuals should be pursued and prosecuted by the companies, the S.E.C. or other law enforcement agencies. The question is whether or under which circumstances the S.E.C. should also seek a court order to enjoin the company against a repetition of such abuses.

Some have misinterpreted the commission's discussions of corporate vs. individual sanctions as a proposal only to charge executives and never charge corporations. This has never been suggested. There have been no proposals, and it is not an "either/or" issue. Rather, the question is how to best serve investors. Depending on the facts of the case, investors are sometimes best served by sanctioning corporations, and at other times executives, or both.

The commission's actions, by law, must be remedial, not punitive. The commission therefore brings injunctive actions in the courts to prohibit a repetition of violations and to obtain equitable and ancillary relief.

When the commission brings such actions against a company, the company incurs significant legal and other costs, as well as adverse publicity, at the ultimate expense of its shareholders.

Individuals who have absconded with funds would prefer that their companies were prosecuted, rather than themselves.

The other commissioners and I have concluded that such situations should be considered on a remedial case-by-case basis.

Cases are typically brought before the commission a year or more after the event. A critical consideration for the commission and the courts is the likelihood of a recurrence of the abuse. Factors to be considered include the nature and consequences of the abuse; whether the perpetrators are still with the company or have no interest in it; prior or subsequent infractions of the securities laws, and the company's efforts to prevent a repetition of such abuses.

THERE is no question as to whether actions should be brought against companies that have been the beneficiaries of misdeeds. If a company has received ill-gotten gains, it must be compelled to disgorge them. If it has raised money on a false or misleading prospectus, it must be subject to recision and other sanctions. If it issues false or misleading disclosure documents, it must be compelled to restate them. These are but a few of the many instances in which the S.E.C. should and does bring actions against companies. Egregious violations by companies or employees may also result in criminal prosecutions by state and Federal law enforcement agencies.

Most of the commission's cases are settled under consent decrees in which the defendants neither admit nor deny the charges, but agree not to engage in such activities in the future. Subsequent violations may result in criminal contempt proceedings. In addition to permanent injunctions, the settlements may also include equitable relief and various undertakings. Actions by the commission are also often accompanied by civil suits by shareholders and others, as well as criminal prosecutions that may result in fines or imprisonment.

The following cases illustrate the variety of commission cases and settlements:

- A permanent injunction was entered against a plant manager who was charged with falsifying corporate records and altering auditors' worksheets. No action was brought against the company because as soon as the falsifications were discovered the manager was fired, the company's public financial statements were restated and improved accounting controls were installed.
- The commission obtained an injunction and ancillary relief from a restaurant chain and two of its former officers, who were charged with receiving kickbacks from vendors, falsifying books and records, and diverting corporate funds to their personal use.
- As a result of alleged antifraud, periodic reporting and proxy solicitation violations by a discount department store chain, the company consented to a permanent injunction against future violations and to the appointment of an outside chairman of the audit committee and a senior accounting executive. The chairman of the board filed an undertaking with the court, acknowledging that he was subject to the final judgment.
- Two former officers of a public company who allegedly falsified the company's books and records and diverted more than $3 million into a family enterprise, were permanently enjoined, but not the company. A substantial portion of the funds was recovered.
- As a result of alleged reporting and antifraud violations by a manufacturer, the court enjoined the company, but no specific executives, against future violations and ordered the company to amend its financial statements and appoint a majority of outsiders to its board.
- Five corporate executives and their company were permanently enjoined from future reporting violations. One of the executives, who was also charged, among other things, with using corporate funds to renovate his house, was also prohibited for 10 years from being an officer or a director of a public company. He was also required to disgorge funds spent on his house and not to vote his shares against matters recommended by a majority of the board.
- The commission obtained a permanent injunction against the general manager of a food company subsidiary for alleged falsifications of inventory reports over a period of years and misrepresentations to the corporation's auditors. The corporation was not named because upon discovery of the fraudulent reports, it immediately made the matter public, accepted the manager's resignation and hired an independent accounting firm to conduct an investigation, which resulted in improved internal accounting controls. There was no evidence that the parent company's management was aware of the falsifications and the company cooperated fully in the commission's investigation.

Thus, there is abundant precedent for sanctioning individuals, corporations or both. It is not an "either/or" issue. It depends on the facts in each case. ■

John S.R. Shad is the chairman of the Securities and Exchange Commission.

Senator PROXMIRE. Go ahead.

Mr. SHAD. The statement you quoted was a misquote and inaccurate and was also fully responded to in a New York Times piece. I wonder if you have that because it's a very specific response, in which all the Commissioners concurred, which is what I advanced at the outset in raising the question. That is that these cases have to be considered on a case-by-case basis.

Now the proposition that I raised was whether we do more harm than good for the shareholders by bringing actions against companies that former officers and directors have victimized. They have absconded with funds.

Let's take the situation where an executive steals from the corporation and flees. In bringing an injunctive action, the first question is whether we can even sustain it in the courts. Injunctive actions are to prevent a repetition of the act. Well, the person who committed it is long gone. The company has been the victim, not the perpetrator of the abuse, and by bringing an action against the company in some circumstances we impugn the corporation and make it more difficult for the company to hire good executives because they're concerned about the image and reputation of the company they become associated with, and we impose great burdens on the company when the bad guys have long departed the scene. We're trying to enjoin a company from repetition of past miscreant misconduct.

COMPANIES HAVE A RESPONSIBILITY FOR EMPLOYEES

Senator PROXMIRE. If I could just interrupt at that point, Mr. Chairman, I'm shocked. It seems to me that the company has a responsibility for its employees, and full responsibility, and if the employees get out of line the company should be held to account.

Mr. SHAD. I agree with you. The cases in which we have not brought actions against the corporation—and there have been a few—and gone against the individuals have been those in which the company—first of all, there's 1 year or sometimes 2 or 3 years between when the acts occur and when the case has reached the Commission, and during the interim period we have many cases in which the companies have first fired the individuals responsible for the misconduct, have installed effective controls to be able to detect future repetition of it, and taken a whole series of actions including restating their financial statements, often before any sanctions or pressures have been brought by the SEC.

And in those cases, the Commission has unanimously concurred in the decision not to sanction the company but rather to go against the former employee.

So I agree with you that if we have a case in which somebody has absconded with funds and you have no reason to believe that they have effective controls in the company to prevent a repetition of that misconduct, we have to bring an action against the company.

Senator PROXMIRE. Mr. Shad, you indicated that I misquoted Commissioner Treadway. I have in my hand here this memorandum——

Mr. SHAD. No. I said you misquoted me. In fact, what you did was quote a partial statement without the amplification which I just made. As far as Commissioner Treadway is concerned, you're absolutely accurate, and I would also add that Commissioner Treadway would be the first to say that when I informally solicited the views of the other Commissioners and senior staff in this area he had no expectation that that statement was going to be in the press or aired in Congress. I agree with his bottom line. In fact, if you review the testimony in the House on the same point, there was concurrence by all three Commissioners on how to deal with these kinds of problems and basically it's on a case-by-case basis.

I was characterized in the New York Times as having said we should only bring action against employees, never against the company. That's outrageous. I have never said that and that was the implication also, I believe, in your opening characterization. I've never said that.

Mr. FEDDERS. Senator, could I comment on that?

Senator PROXMIRE. Sure.

Mr. FEDDERS. I've learned in 2½ years that the Commission is a place of great intellectual nudity. It's not a place where anyone should ever fear of raising a question—the most junior staff member to the most senior person, Chairman Shad—should ever be concerned in raising an issue. This issue was raised with great integrity and I would tell you that after having heard every Commissioner, every staff member discuss this at length, that the difference of opinion is almost razor thin. I do think certain statements have been taken out of context. There is no message in any place of the Commission to go soft on anyone. We target no one. We elect to go soft on no one.

The great thing that has happened is that there is intellectual nudity. People are free to raise issues, to question old ideas, to try to make it a healthy and vital place. Today if there is any disagreement on this very issue, it's razor thin.

Senator PROXMIRE. I don't question any of that. I just wanted to quote Mr. Treadway who seems to take a different position, and you respect that position.

Mr. SHAD. I do.

Senator PROXMIRE. Now you testify that you agree with him in part.

Mr. SHAD. I concurred with him, and we have talked about it.

Senator PROXMIRE. Let me proceed then and get back to what Chairman D'Amato was asking about. Mr. Shad, you testified in the House that inside trading could be defined. You said, "it could be a very specific definition" and you said, "It would be possible to define who is an insider." And you suggested that "in cases where punitive sanctions are sought that you have a definition." Later you changed your position and opposed adding a definition in the bill concluding,

> The Commission believes existing law is sufficiently clear to provide guidance as to prohibited transactions. A new statutory definition would necessarily incorporate new terms and concepts which would create more uncertainties and spawn future litigation.

Why the flip-flop? It almost sounds as if you're running for President.

Mr. SHAD. I think the first statement was my personal opinion. The second was the Commission's position. I think everyone who has addressed this area initially feels intuitively and emphatically that we should have a definition. We don't want to have ambiguity and uncertainty that's going to cause corporate executives, for instance, to inhibit desirable conduct for the benefit of shareholders for fear of exposing themselves to enormous penalties. We don't want to put high compliance costs on the securities industry because a fear that a broker executing transactions in the pell-mell of daily trading activities may later be deemed an aider and abettor of an insider trader. The huge liability and fines will in turn simply be passed through to the investing public; they will be borne in the final analysis by investors. So we would be greatly reducing the benefits we are trying to confer on investors if we inhibit desirable conduct or impose heavy compliance costs to their detriment. So that's where I started. I felt that if we had a specificity it would not have a tendency to increase the compliance costs or inhibit desirable conduct.

COMPLEXITY OF DEFINING ALL THE ISSUES

But as I've gotten into this issue, I've appreciated more and more its complexity, and the big risks of not coming out with a bill, of tying this thing up in a definition debate that could go on forever. It's so complex. A recurring issue is whether it should be narrower or broader. Should we attempt to codify the present state of the law and risk undue rigidity? There are those who would argue that preserving the flexibility of the courts to deal with the evolving problems and new techniques is better than adopting a rigid codification.

Senator PROXMIRE. Then, as I understand your position, you're against a definition in the bill because it would delay the bill and for other reasons.

Mr. SHAD. Well, no; I won't accept that. What I have said today is on behalf of the three sitting Commissioners, and, I hope, two more soon, we have not had an opportunity to formally sit down and look at, on a comparative basis the present state of the law and the subcommittee's proposed approach. I think it's got a lot of appeal. So before you sign me off, I think I'd like to get all full evidence and make a careful consideration of the new approach.

Senator PROXMIRE. At any rate, you come down on the side of no definition.

Now, Mr. Fedders, you testified in the House——

Mr. SHAD. Wait——

Senator PROXMIRE. Did you not? Didn't you say you came down on the side of no definition?

Mr. SHAD. No, damn it. [Laughter.]

Senator PROXMIRE. Now I'm really puzzled.

Mr. SHAD. I thought I said it clearly.

Senator D'AMATO. You got 6 for and 6 against.

Senator PROXMIRE. I'm going to deal with Mr. Fedders on that, but it would be nice if you fellows said you want the definition or don't want a definition. If you want one, what is it?

Mr. SHAD. I think the more you appreciate the problem, the more difficult it is to say flatly that you're opposed to a definition or you're in support of it.

Senator PROXMIRE. You want us to feel the same kind of deep intestinal pain that you feel?

Mr. SHAD. Thank you.

Senator PROXMIRE. Now with that in mind, Mr. Fedders, you testified in the House,

> I happen to have confidence that we could come up with a definition, and I do not run away from it. I do not abandon that idea, but it is very difficult. One of the things I realize is once I do a definition that I can live with and I hope my colleagues are proud of, that it is going to be subject to a lot of challenge in the Congress.

Leave the challenge to us. What is the definition you would come up with? You gave us six on the one hand and six on the other and, like Harry Truman, I'm looking for someone to give me one-handed advice.

Mr. FEDDERS. Well, it pains me to tell you this, Senator. My advice would be to accept from the Commission——

Senator PROXMIRE. I'm sorry. What was that again?

Mr. FEDDERS. To accept from the Commission a law that would not be a codification of existing case law, that would not attempt to narrow or restrict the law, but that would be a supplement to the antifraud provisions.

I don't see how anyone who wants to attack this form of misconduct can ever attack something that supplements the enforcement remedies available to the Federal Government. Consequently if we had a supplemental rule, that's essentially what's in the Freeman definition here, I see no reason—how can anyone attack something that is supplemental to law enforcement to help us do our job? But I don't want a definition that causes me problems in other litigation. I don't want your definition, Senator. Frankly, I want my definition because I'm the guy who has to do the prosecuting. I say that obviously respectfully and very quickly respectfully.

Senator PROXMIRE. Thank you. I have other questions but I yield back to you.

Senator D'AMATO. What is your definition? Now you've got me going round and round.

Mr. FEDDERS. After 5 months of work, we're close. This is a difficult task. If we're asked to continue to work, I'm sure we can come up with something. But at the present time, I don't have anything, Senator, that I would be proud to hand to you.

The reason you put the work in at this end is once it becomes law, then you have two decades of litigation, and we don't want that.

Senator D'AMATO. But again, in terms of supplementing the existing law, I think quite clearly that it's necessary, that in certain cases we've got people driving trailer trucks through loopholes. So I think your effort is important and I think the fact that we've got this bill up in this manner to focus in on this issue is important. We simply can't take the position that because we may get litigation with respect to a new definition that we shouldn't go forward. I don't think it's going to impede prosecution since it will supple-

ment the existing law and it certainly isn't going to cause us to lose any cases.

SEC'S INVESTIGATION OF TOM REED

Let me focus on something else. Last year we held hearings on the SEC's investigation of Mr. Tom Reed. That's the case where the fellow traded with the options and he wanted to put all his options in his friends' names and give them a wonderful charitable gift.

The Commission ended up entering into a consent agreement with Mr. Reed in which he promised to behave in the future—I couldn't believe that—and that he'd return the profits. Now had it been necessary to litigate, wouldn't the fact that Mr. Reed had purchased options and not common stock been a problem for the Securities and Exchange Commission in pursuing litigation against him?

Mr. FEDDERS. I can confidently say to you, Senator, that I don't think so. I am aware of some cases that are of the point of view that rule 10b-5 covers it and the way we use it in our insider trading program covers only equities securities and there are some points of view out there that says it does not cover the options market. I think they are wrong. I think we can sustain our point of view, but, yes, I recognize the point that you make.

Senator D'AMATO. But isn't this a gray area that needs some clarification. Wouldn't it help to have more clearly defined language to insure that options trading is included in insider trading laws?

Mr. FEDDERS. Any time Congress can clarify a law on a cost-benefit analysis, it's helpful to us.

Senator D'AMATO. Do you have a suggestion in that regard?

Mr. FEDDERS. At this time I don't, Senator, but certainly——

Senator D'AMATO. I was going to say don't give me six reasons for and six against.

Mr. FEDDERS. The language that Mr. Goelzer and I and his colleague, Diane Sanger, whom I think you're familiar with, who has just done an absolutely marvelous job in working with some of Dan's colleagues who have just done a terrific job on working with this, but we're not done. If we send something over, it will be Tiffany in every respect.

Senator D'AMATO. How long can I wait for Tiffany?

Mr. FEDDERS. Some great diamonds take a very long time, but we hope you don't have to wait much longer. It will be good when you get it.

Senator D'AMATO. Mr. Fedders, I understand that you believe insider trading has increased because of the enormous increase in tender offers and mergers and the necessity to put less capital at risk when investing in the options market and the ease with which individuals can execute transactions in the U.S. capital markets from foreign jurisdictions with secrecy and blocking laws have created some very real problems.

Could you please explain for the record exactly what the secrecy and blocking laws are doing and how they have created this problem?

SECRECY AND BLOCKING LAWS

Mr. FEDDERS. These laws, Senator, are impeding the efforts of the Commission to protect investors and to police our capital markets. Secrecy laws exist in about 14 foreign nations, countries such as the Bahamas, Cayman Islands, Hong Kong, and Switzerland. Secrecy laws are confidentiality laws which prohibit the disclosure of business records and the identity of bank customers.

Blocking laws are quite different. They grew out of the alleged extraterritorial application of our antitrust laws. The two prominent blocking statutes that we frequently confront are in the United Kingdom and in France. Blocking statutes generally embody national interests and prohibit the disclosure, copying, inspection or removal of documents located in the territory of the enacting state in compliance with orders of foreign authorities. There are about 15 foreign jurisdictions which have blocking statutes.

Senator D'AMATO. Let me ask you something. Am I correct that your insider trading prosecutions involving the St. Joe's Mineral Corp. and the October 1981 announcement of the merger of Santa Fe and Kuwait Petroleum were impeded by the Swiss secrecy laws?

Mr. FEDDERS. You're right in both cases, Senator. Both of those cases illustrate the problems that we've encountered in policing our international capital markets and confronting foreign secrecy and blocking laws. In each case, we alleged that wrongdoers executed transactions through foreign banks in our capital markets and then when we attempted to learn their identity the foreign banks said, "I'm sorry, but there's a secrecy law applicable here and we cannot provide you the identity of the customer."

In the *St. Joe* case, we eventually brought a rule 37 motion to compel. After about an 8-month delay we received the name of Guiseppe Tome. We can now continue with our prosecution. In October 1981, after the announcement of the Kuwait Petroleum-Santa Fe transaction, we could tell from our market surveillance that a number of people had executed transactions through five different Swiss banks. We immediately brought an action in the Southern District of New York, froze assets, and since that time, 2½ years, have been working with the Swiss Government to get the identity of these individuals.

But law enforcement can only be effective if it's swift and economical. Unfortunately, here we have been impeded in our progress. We are hopeful. The Swiss have worked with us. We are hopeful that we will obtain the identities of the individuals in the late spring of this year.

Senator D'AMATO. Well, let me ask you something. How does this kind of transactions that you suspect were taking place—how does that hurt the little fellow right out there in the marketplace? Can you describe that, and what's the solution to this problem?

Mr. FEDDERS. Well, it does hurt the little guy substantially. It hurts everyone in our capital markets. I think what has happened by reason———

Senator D'AMATO. What did you suspect was taking place in that particular case, the *St. Joe's* case or the case you just referred to?

Mr. FEDDERS. Well, the *Santa Fe* case, because the market surveillance unit in the Division of Enforcement showed that pur-

chases of deep out of the money options had occurred immediately preceding the announcement of the Kuwait-Santa Fe transaction, it was likely that someone had inside information. The striking price of the options had nothing to do with the then market price of the stock. Then 3 days later there's an announcement of the transaction. The stock took an enormous jump and these people made millions of dollars.

Senator D'AMATO. You're talking about millions. How much?

Mr. FEDDERS. Well, in the $10 million area.

Senator D'AMATO. $10 million?

Mr. FEDDERS. Yes; we froze a little less than that. We still have under freeze the money before Judge Connor in the Southern District of New York.

Senator D'AMATO. That's $10 million that people lost?

Mr. FEDDERS. Not only that they lost, but there were naked options written on the Pacific Stock Exchange and some of those folks have gone bankrupt because of this.

Senator D'AMATO. So people are out of business and a lot of people lost profits they would have otherwise made.

Mr. FEDDERS. Most were options so I don't know that they would have had profits, but they were naked. They wrote naked options and, consequently, they had to buy into the market because they were naked.

A DE FACTO DOUBLE STANDARD

But one thing I don't want to miss mentioning. You asked the question about how is the little guy hurt. What these secrecy and blocking laws have done to our market is they've created a de facto double standard. One standard of law enforcement for those who choose to effect such transactions from beyond our borders through intermediaries secrecy or blocking jurisdictions, and another strict standard for those who trade within our country. We have easy access to those individuals and can certainly enforce our laws, but we are impeded when confronting individuals hiding behind secrecy and blocking laws.

Senator D'AMATO. Do you have any suggested approach to deal with this problem?

Mr. FEDDERS. Well, Senator, there are three possible approaches that we could take. We could take a bilateral approach on a country-by-country basis. That would take an enormous amount of time. We could take a multinational approach, but I suggest that that would take years and I don't think the integrity of our market can wait for that. The third approach is a unilateral approach. At your request and Chairman Dingell's request, I wrote each of you on March 30 discussing possible legislation that I characterize, and John Shad spoke of in his introductory statement, as the waiver by conduct idea.

The rationale of this concept is that individuals and financial institutions who effect securities transactions in our markets make a deliberate and a voluntary decision to engage in conduct within this Nation. They do so in order to take advantage of what John Shad calls the fairness, the most efficient, and the cheapest markets in the world.

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If a waiver by conduct law were enacted, foreigners would automatically waive the protections of secrecy laws as a precondition for engaging in securities transactions in the United States. Such waivers would be implied by the fact that the transaction took place in our markets. The United States could require that foreign investors make an explicit choice—either forego the investment opportunities available here, or give up the protection of foreign laws that might be used to conceal the identity of the investor and the circumstances of the transaction.

This concept is not an exterritorial application of U.S. laws or an infringement on the sovereignty of other nations. People who conduct transactions through foreign institutions in our markets are engaging in conduct in the United States. They are making a direct and intentional decision to take advantage of our markets. Those availing themselves of this privilege thereby submit to the jurisdiction of the United States and leave the protection of secrecy and blocking laws behind. Indeed, it is the exterritorial assertion of foreign laws that impedes the SEC's efforts to police our markets.

It's not a panacea. There are both pros and cons, and I set out about a dozen pros and cons in my letter to you.

Senator D'AMATO. Is there any administrative burden on the firms with regard to your proposal?

Mr. FEDDERS. In my view, as I say in my March 30 letter to you, I think they are minimal. Yes. Nothing is free in this society. The administrative burden I think would be minimal—by putting an extra sentence or two in their confirmation orders.

Senator D'AMATO. Before we go to the second panel, Senator Proxmire, do you have any other questions?

Senator PROXMIRE. Yes, I have just a couple and I apologize because I realize we have a very distinguished panel coming up.

Mr. Shad, Christopher Demuth, the Office of Management and Budget's regulatory chief, in an analysis prepared for the Cabinet Council on Economic Affairs on the administration's 1984 regulatory agenda, is reported to have recommended rewriting the securities laws. Specifically he is reported as recommending the elimination of restrictions on insider trading and tender offers. Is that correct?

Mr. SHAD. I'm sorry. I didn't hear a couple of those words.

Senator PROXMIRE. Christopher Demuth—you know who he is—is reported to recommend rewriting the securities laws specifically recommending the elimination of restrictions on insider trading and tender offers.

Mr. SHAD. Yes, I'm familiar with that.

Senator PROXMIRE. He did make that recommendation?

Mr. SHAD. Well, I've never actually seen—I've never had direct communication that he made it. I have heard it reported. I have been told that it has been proposed and actually to be accurate, I haven't been told that there was any proposal on tender offers but on insider trading, yes. I heard there were suggestions, I would say, more in opposition to the proposal of the triple penalty.

Senator PROXMIRE. Is this an administration position in favor of eliminating restrictions on insider trading?

Mr. SHAD. I don't believe so. Dan, do you have anything on that?

Mr. GOELZER. As far as I know, the administration is not proposing that.

Senator PROXMIRE. You don't contest the assertion of Mr. Demuth. It seems to me when he speaks he speaks for the administration.

Mr. SHAD. I don't know. I guess you'd have to ask him to be sure whom he's speaking on behalf of, whether himself or the administration or OMB. But I want to make it clear that all I've heard—and I haven't seen anything in writing and have had no official communication—was the expression of reservations about the proposed triple penalty that we are now here supporting. I've heard that there are people within OMB and others who have serious reservations concerning the imposition of the triple penalty on insider trading, and I could amplify as to the reason if you wish me to do so.

Senator PROXMIRE. Has the administration or OMB expressed to you, as Chairman of the SEC, any position on regulatory reform in the Securities and Exchange Commission?

Mr. SHAD. I know of none, no. We get various forms of communication from OMB, principally concerning our budget, of course. I don't recall any on this subject—although they also require reports under the Regulatory Flexibility Act and other things.

Senator PROXMIRE. This is a very, very serious charge against the SEC I'm going to ask you about and I ask it recognizing that the SEC is still, in my judgment, the best agency in Washington and that you're a man of great integrity and ability and I think you've done your very best as Chairman of the SEC. Nevertheless, I'm disturbed by this statement by a highly respected former Commissioner, Bevis Longstreth, who wrote the following in the New York Times:

> There's a growing risk the SEC would be seen on Wall Street as a paper tiger. This risk is rapidly becoming a reality. Its consequences will be adverse and long term. The SEC's effectiveness over the years has been on creating and sustaining the belief among issuers, securities professionals, their lawyers, and accountants that violations will not go undetected, that there is indeed a cop on the beat along Wall Street. If that belief fades, it will not be restored easily or overnight.

Now again, I want to repeat the fact that I have great respect and admiration for the SEC. It's been a fine agency and it is a fine agency.

IS THE SEC BECOMING A PAPER TIGER?

How do you respond to the assertion that the Commission is rapidly becoming a paper tiger by an insider, a former Commissioner, a man of the integrity and ability of Bevis Longstreth?

Mr. SHAD. Well, I certainly share your high regard for Bevis Longstreth. I think he's an extraordinary person. I strongly disagree with the paper tiger characterization, but that's certainly his privilege.

How can one say that the SEC is becoming a paper tiger when, over the emphatic opposition of virtually the entire securities industry we adopted a shelf registration rule? Why? Because we knew it was saving hundreds of millions of dollars for the benefit of corporations, and, ultimately, investors. We've consistently taken action guided by one principle as far as I'm concerned as a

Commissioner and as an individual, and that's what's in the best interest of the investing public.

Last month, we proposed changes in the tender offer area. We have reviewed the recommendations of our Tender Offer Advisory Committee, and we've testified in support of certain changes in the tender offer rules. On the other hand, we stated that, while the Advisory Committee recommended that we continue to honor, of course, and support the business judgment rule, the Commission's position is that shareholders would be better protected if the courts, in applying the business judgment rule, recognized potential conflicts of interest between management and shareholders. I don't make a one-inch concession to critics that say we are not trying to do an absolutely effective job. I think this is the best Commission the SEC has ever had in terms of the results over the past 2½ years. I'm proud of this Commission. No matter what we do, we're going to get criticism. I accept that; it goes with the territory; but I don't think it's just and I think we're doing a first rate job in protecting investors.

Senator PROXMIRE. How do you answer the criticism then that the SEC has been weakened because you have recommended cutting enforcement funds?

Mr. SHAD. Nobody has recommended cutting the enforcement program. In fact, the enforcement program under my direction has been one of the largest——

Senator PROXMIRE. Don't you have a smaller staff now than you had before in enforcement?

Mr. FEDDERS. It's smaller in relation to 1979, but the support that Chairman Shad has given the enforcement program since he's been there and since I've been there since July 1981 is unqualified. Statistically——

Senator PROXMIRE. That's a nice term of rhetoric but one way you measure that is by the manpower you have in enforcing the law.

Mr. FEDDERS. Senator, if you measure my manpower, then let's measure us by results also. The statistics are as follows: The first fiscal year, fiscal year 1982, 6 percent reduction in staff, 30 percent increase in enforcement actions, 254. Last year, virtually a flat enforcement staff, and a further increase from 254 enforcement actions in fiscal year 1982 to 261 enforcement actions last year. And I accept the thunderous applause.

Mr. SHAD. Senator, could I respond?

Senator PROXMIRE. Yes, sir. The reason I don't give thunderous applause is that I'm not sure the number of enforcement actions brought is the one and only measure of your record.

Mr. SHAD. It certainly isn't, and by all other criteria, we've seen record results. But I think the question is sort of a derivative question based on other things. The other things are that, in the course of budget hearings, I supported the administration's recommendation that we only receive a 3-percent increase in our budget. Actually, if you look at a list of the various agencies, the SEC has had by far one of the largest increases of any of the regulatory agencies. Looking at the budget in 1981 versus the budget that the administration approved for 1985, we've gone up over 33 percent in

that period of time. Most independent agencies have been cut. I'm talking about dollars now.

But it's a matter of record that when OMB proposed our initial budget they made some concessions to us but not enough and we got further increases. We ended up with a 3-percent increase in the budget which necessitated a 6-percent reduction in personnel because of other inflationary costs.

Now everyone in this room I believe—and certainly in the Congress—is very concerned about the size of the Federal deficits. Yet it troubles me that so often after the first breath of criticizing the huge deficits the next breath is, "But I need more. I want more for my agency, my district, my area."

Senator PROXMIRE. Chairman Shad, your agency in the past—and I haven't been associated with this in the Appropriations Committee recently—has been financed in large part by industry registration and administrative fees. Isn't that correct?

Mr. SHAD. We earned a profit in 1983.

Senator PROXMIRE. You bring in more money than you cost?

Mr. SHAD. Yes.

Senator PROXMIRE. So that the argument that you balance the budget by cutting the enforcement staff of the SEC, or the enforcement funding of the SEC, or holding it down to 3 percent does not seem to me a sensible fiscal move, or very persuasive.

PERFORMANCE OF SEC IMPROVED BY NEW TECHNOLOGY

Mr. SHAD. Well, I don't think in fact you want to balance the budget that way. If you eliminated the entire cost of the SEC, we would still be generating transfer and filing fees, so it would be a 100-percent profit. But I by no means advocate that obviously. I made the statement that, because of ongoing productivity improvements we could maintain our present level of activity despite a 6-percent reduction in personnel. We've more than done that. In every major division, we have achieved record results or the highest levels in several years in each of the last 2 years despite a 3-percent reduction in personnel over that period. We're doing, I think, a terrific a job in improving performance through productivity by going to computers, by upgrading the speed and the efficiency of our entire activity, and we've got much bigger and exciting things in prospect. We are dramatically improving the productivity, efficiency, and effectiveness of this Commission.

Senator PROXMIRE. Let me ask just one more question, Mr. Chairman, and again I apologize for taking so long.

Mr. Shad, how do you respond to the assertion of Michael Kline of the law firm of Wilmer, Cutler, and Pickering and others, and I quote:

> The additional appropriations and oversight may be more significant than amending the substantive statute. Instead of amending the law, you need more resources to enforce the law you have.

Mr. SHAD. We don't know the extent of undetected crime and that's true whether it's SEC, FBI, or anybody. It's true that, if we had more resources, we would bring more cases, we would pursue more wrongdoing. That's a judgment for Congress. It's a very difficult one. Where do you draw the line? I don't think there's any

question that if we doubled our budget there would still be areas in which we could still go beyond that. So do you triple it, quadruple it, or conclude that the SEC already has a very visible presence that is having a dramatic inhibitory effect on securities fraud. I believe we have. Judging by linage in newspaper articles, it's gone up dramatically in the past 2 years. You can't pick up an issue of the Wall Street Journal today without seeing a story about the SEC's charging somebody with either securities fraud, or insider trading, or manipulation. The same is true of the New York Times, a general news publication.

So the SEC with this limited budget and this small staff is having a dramatic impact and visible impact because it's those stories that inhibit people from engaging in questionable conduct.

Mr. FEDDERS. Senator, could I just comment on one thing? I think my friend, Bevis Longstreth, wasn't calling us a paper tiger today. He just feared that we could become one.

Senator PROXMIRE. He said the danger of becoming one.

Mr. FEDDERS. We all have to be concerned with whether we might become one. The goal right now for the enforcement program is not to target it in one area. Insider trading gets enormous publicity because people can understand it and even people in the press can understand it and they can write about it.

Senator PROXMIRE. You said even the press?

Mr. FEDDERS. I don't know that I said that. We can check that. Eight percent of our resources—the goal today in the enforcement program is breadth and presence and seeking new ideas, new ways to attack different problems on the street, and that's really where we're being successful. I don't look to the insider trading book as a success or financial fraud, but are we successful in breadth and presence of the program; and that's the thing where it's a credit to all the enforcement attorneys, not to John Shad or myself or the other Commissioners or soon to be Commissioners. It's to the credit to these young people who are there day in and day out. When people criticize us, they're not really hurting us. The talismans are there. But it's hurting the staff people and that's the thing that I feel bad about.

Senator PROXMIRE. Thank you, Mr. Chairman.

Senator D'AMATO. I want to thank the Chairman, Mr. Fedders, and Mr. Goelzer. I'd ask you, if you would attempt to get some suggested legislative language to us. My inclination certainly is not to impede the enactment of the treble damages provision which I think is absolutely essential. I'll confer with the entire committee, particularly with my distinguished colleague, Senator Proxmire, with respect to just how we should continue to move this. We don't want to get bogged down in a situation where we have no legislation. There's no pride of authorship; but by the same token, I am not satisfied with the language that comes over from the House bill. I think that while it does address important areas with respect to seeing to it that those who do engage in insider trading pay an appropriate penalty—and I'm not so sure that that penalty is even large enough, it doesn't include a definition—however, it certainly is a step in the right direction. I think that we've got to work toward seeing to it that those gray areas are no longer gray and

enact legislation that will deal comprehensively with the problem. It's absolutely essential.

So while I'm not saying to you the language which has come over from the House side won't be amended to include a definition, I am pledging one thing, we're not going to get this mired down to the extent that we don't have any legislation on it at all. I think that would be a terrible shortcoming on our part. We are definitely going to get some legislative action this year. Both Senator Proxmire and I feel very strong in that regard.

Mr. SHAD. May I make a very brief statement?

Senator D'AMATO. Certainly.

Mr. SHAD. First of all, I want to applaud Chairman D'Amato for raising two critical new areas and ventilating some very desirable concepts. But I also want to say to Senator Proxmire how much I respect him and appreciate the tough questions he was advancing because it did give me an opportunity to respond, and I appreciate that, Senator.

Senator PROXMIRE. Thank you, sir.

Senator D'AMATO. Thank you very much.

Let me apologize to our second panel for the amount of time we took with our first panel, but obviously, as you saw, with the interest in the questions, we couldn't do anything less. I want to thank all of you for participating not only here today but also in terms of your communications and contact with the committee and indeed the effort and thought that you have given to this most important matter.

Why don't we start it off and we will take all of your testimony for the record in its entirety. You can summarize that which you feel is important and the Chair is not going to attempt to put any restrictions on you with regard to time because we think that this is a rather important issue.

STATEMENT OF MILTON V. FREEMAN, ESQ., PARTNER, ARNOLD & PORTER, WASHINGTON, D.C.

Mr. FREEMAN. Mr. Chairman, thank you for the opportunity to testify. My statement has all that I wish to say on the merits of the matter. I want to thank you for your kind reference to the proposal and the asssociation of my name with it. I'm pleased and proud to be associated with it.

More than 40 years ago I was Assistant Solicitor for the Securities and Exchange Commission and dealing with the question of insider trading. In one day we adopted a rule to prohibit purchases on the basis of insider trading, now known as rule 10b–5. And 40 years later, when I suggested in House testimony last year an extension of that rule be made to deal with outsider trading, not unexpectedly, it did not receive similar unanimous and immediate approval. However, I was very pleased today to hear the testimony of the Securities and Exchange Commission. Although I had understood that they might be opposed to the matter, I'm pleased that today they indicated they are not opposed to adopting legislation which supplements rule 10b–5 and gives the Commission additional powers which I think they should have.

While Mr. Fedders had a weekend to consider this rule, I hope when he has more time and when the Commission as presently constituted or as supplemented considers the matter that they will see that the proposal which is attached to my testimony is desirable. That draft is slightly different from what has been on the table. I think it is clear and simple. It would present no problems and I would suggest when the Commission gets down to think about it, they will realize that this is a great additional power which they should have. It would serve the interest of what you, Mr. Chairman, have proposed as a necessity for assuring the public that the securities markets are less subject to manipulation by unfair trading.

I would urge that careful consideration be given to the rule which would outlaw trading by people who unfairly use information of such a character that gives them a great advantage over the general market because the information will affect the market price by raising it or lowering it substantially immediately upon release.

I want to thank the Senator for the fact that I have been consulted, as the other people on this panel have been consulted. I have had a chance to talk to Mr. Levin. We had a meeting with the SEC and the draft which is attached to my testimony is the result of careful consideration of the points of view of various segments of the community and I'm pleased that it's made so much progress.

Thank you very much.

Senator D'AMATO. Thank you very much.

[The complete statement follows:]

STATEMENT OF MILTON V. FREEMAN BEFORE THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS OF THE UNITED STATES SENATE

April 3, 1984

My name is Milton V. Freeman. I am a partner in the Washington, D.C. firm of Arnold & Porter. My career has been largely in the practice of securities law.

From 1934, when I graduated from the Columbia Law School, until 1946, I was employed by the Securities and Exchange Commission and its predecessor, the Securities Division of the Federal Trade Commission. From January 21, 1946 to date, I have been with my present law firm, variously styled Arnold and Fortas, Arnold, Fortas & Porter and Arnold & Porter.

I was for some years Chairman of the American Bar Association Subcommittee on SEC Practice and Enforcement Matters, and am now a member of the Executive Committee of the Committee on Federal Regulation of Securities. I want to make it clear that the views I express are purely personal -- that they have not been submitted to or cleared with the American Bar Association. I am not authorized to, nor do I purport to, speak for that organization or any part of it, nor indeed for my partners or for any client. The views I express are my personal views which I commend to this Committee only for such consideration as they may deserve on their merits.

While I was employed by the Securities and Exchange Commission, in the year 1942, I participated in the drafting of Rule 10(b)(5), which has been the principal provision under which the Securities and Exchange Commission and the Department of Justice have brought litigation against the unfair use of information.

I testified before the House Committee on Energy and Commerce, Subcommittee on Telecommunications, Consumer Protection and Finance on H.R. 559, on April 13, 1983, and both previously and subsequently have written on the subject in various publications. I believe the statement of my position up-to-date is best set forth in my recently published article in the Pace Law Review, which contains reference to my previous writings. Copies of that article are attached.

In substance my position is, for the reasons stated in that article, that the time is ripe for the Congress to adopt a new statute which would outlaw unfair use of information. My position is that Rule 10(b)(5) is inadequate to this purpose and that accordingly new legislation is necessary which will not be phrased in terms of fraud. Such new legislation would make illegal unfair use of information and subject it to penalties and forfeitures without the necessity of the SEC proving scienter and

other elements of fraud. It would leave untouched and in full effect antifraud rules such as Section 10(b) and 14(e) of the Securities and Exchange Act and the rules adopted under those sections. I submit there can be no legitimate objection to such legislation as my writings, I believe, have established.

I respectfully solicit the consideration of such legislation by the Committee. I have seen a draft bill to that effect with which I agreed. I understand it is to be modified in a manner with which I do not agree. I understand the draft to be presented will outlaw trading on the basis of nonpublic material information even though the information is not of such a character as may be expected to affect the market price of the securities in question. This seems to be much too broad, *e.g.*, information re long range market developments which would be "material" in a registration statement but would not be expected substantially to affect the market value of a security should not be regarded on the same level of impropriety as *e.g.*, news of an impending tender offer. For that reason I have attached a form of bill which seems to me preferable.

Commentary

The Insider Trading Sanctions Bill — A Neglected Opportunity

MILTON V. FREEMAN†

I. Introduction

The Securities and Exchange Commission (SEC) has proposed a bill, H.R. 559,[1] tripling the penalties for what it calls insider trading. The Bill, an additional enforcement tool which may be accepted by the Senate, has so far met no substantial objections. It has passed the House.

The Bill, however, proceeds on the basis that what the SEC views as "insider trading" is adequately dealt with by the Commission's existing Rule 10b-5.[2] It does not seek to amend or modify the substance of that Rule, but only to create an additional penalty for that which is illegal under the Rule.

It is submitted that this is an unduly narrow approach. Recent Supreme Court decisions have made it clear that section 10(b) of the Securities Exchange Act[3] and Rule 10b-5 were designed only to prohibit uses of nonpublic information that amount to fraud.[4] Yet many uses of nonpublic information may be unfair without amounting to fraud. The time has come to en-

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† A.B., City College of New York; LL.B., Columbia Law School; Partner, Arnold & Porter, 1200 New Hampshire Ave., N.W., Wash., D.C. 20036; Ass't Solicitor, SEC, 1942-1944. The author wishes to express his appreciation for the assistance of his colleague Eric Summergrad in the preparation of this Commentary. Mr. Summergrad also participated in the preparation of the briefs in the Supreme Court in Dirks v. S.E.C., 103 S. Ct. 3255 (1983), in which the author's firm represented Mr. Dirks.

1. H.R. 559, 98th Cong., 1st Sess. (1983). The Bill has been denominated the "Insider Trading Sanctions Act of 1983."

2. 17 C.F.R. § 240.10b-5 (1983).

3. 15 U.S.C. § 78j(b) (1982).

4. *See* Dirks v. S.E.C., 103 S. Ct. 3255 (1983). *See also* Chiarella v. United States, 445 U.S. 222 (1980).

act a separate and specific statute broadening the class of activities outlawed. This statute would not be limited to frauds covered by Rule 10b-5, but rather would be designed to outlaw transactions involving unfair use of information, whether inside or outside,[5] and regardless of whether shareholders were defrauded. The objective would be to protect the reputation of the markets as fair places to deal and not as a gambling game where marked cards are permissible.

II. The Scope of Rule 10b-5 and Proposed Bill H.R. 559

Rule 10b-5 was adopted some forty years ago to deal with a case of fraudulent use of truly inside information.[6] The Rule was adopted because of a report that "the president of some company . . . is . . . buying up the stock from his own shareholders at $4.00 a share, and he has been telling them that the company is doing very badly, whereas, in fact, the earnings are going to be quadrupled and will be $2.00 a share for this coming year."[7] That case involved not only direct misrepresentation but violation of a fiduciary obligation of disclosure owed by the president of the corporation to the shareholders in his own corporation, conduct plainly amounting to common law fraud.

As a result of the adoption of Rule 10b-5 purchasing or selling by corporate insiders on the basis of such inside information has been unquestionably illegal for more than forty years.[8] Such conduct has been subject to criminal penalties,[9] SEC injunctive

5. "Inside" information is information coming from inside the corporation — such as earnings figures or new products — which is confidential information intended to be available only for a corporate purpose and not for the personal benefit of anyone. "Outside" or "market" information is information — such as the fact that a takeover is planned — which is likely to have an effect on the market for the company's stock. The Supreme Court has refused to draw a distinction between the two types of information for purposes of Rule 10b-5. *See* Dirks v. S.E.C., 103 S. Ct. at 3262 n.15; Chiarella v. United States, 445 U.S. at 241 n.1 (Burger, C.J., dissenting).

6. The author, in 1942, was co-draftsman of Rule 10b-5 in his capacity as Assistant Solicitor of the SEC.

7. Freeman, *Administrative Procedures*, 22 Bus. Law 891, 922 (1967), *cited in* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212-13 n.32 (1976), *quoted in* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 767 (1975) (Blackmun, J., dissenting).

8. Likewise, outsiders who improperly receive inside information from insiders ("tippees") may acquire the same duties as an insider and may be prohibited from trading on that information. *See generally* Dirks v. S.E.C., 103 S. Ct. 3255 (1983).

9. Securities Exchange Act of 1934, § 32(a), 15 U.S.C. § 78ff (1982).

proceedings,[10] and to the right of the defrauded shareholder to recover civil damages.[11] The law on this point is unambiguous, and requires no clarification or amendment.

The SEC-sponsored Bill would increase the penalties for any person found to have violated section 10(b) and Rule 10b-5 "by purchasing or selling a security while in possession of material nonpublic information."[12] It does not purport to broaden the scope of what constitutes a violation under section 10(b) of the Act and Rule 10b-5. But the incentive for the Bill is the unfairness observed by the Commission in cases where persons have knowledge of impending tender offers or other similar developments and trade on that knowledge to their profit.[13] Typically in such cases, the persons sought to be punished are not officers, directors, or other insiders of the corporation, but rather outsiders obtaining "market" information from the outside tender offerors or persons related to those tender offerors. In my judgment it is extremely difficult to suggest that such persons owe the kind of fiduciary obligation to the persons with whom they deal, or commit the fraud that Rule 10b-5 was intended to deal with, or indeed fall within any possible extended scope of the Rule.

Unfair use of information by outsiders such as tender offerors should not be treated on the same basis as insider trading by corporation officials dealing with their own shareholders. The two categories of transactions are in practice and in legal theory completely different and require distinct treatment. Thus, it is a misnomer to call the proposal an "Insider Trading Sanctions

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10. Section 21(d) of the 1934 Act authorizes the Commission to

> bring an action in the proper district court of the United States, the United States District Court for the District of Columbia, or the United States courts of any territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices [in violation of the securities laws], and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond.

Id. § 78u(d).

11. The right of defrauded shareholders to recover damages under Rule 10b-5 was recently reaffirmed in Herman & MacLean v. Huddleston, 103 S. Ct. 683, 686-87 (1983).

12. *See supra* note 1.

13. *See, e.g., Insider Trading Sanctions Act of 1983: Hearings on H.R. 559 Before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy & Commerce*, 98th Cong., 1st Sess. 17, 19-20 (1983) [hereinafter cited as *Hearings*] (comments of SEC Chairman John S. R. Shad).

Act" when its motivation is, in fact, to deal principally with unfair use of information by outsiders.[14]

The fundamental legal obstacle is that in true insider trading, such as the case which occasioned the adoption of Rule 10b-5,[15] an officer of a corporation is trading in shares with one of his own shareholders to whom he owes a strong legal, indeed a fiduciary, obligation to advise truthfully as to the affairs of the corporation.[16] This behavior is properly covered by a rule against fraud because the conduct of the officer is clearly fraudulent under established common law standards, and his shareholder is a defrauded party.[17]

In comparison, an outsider not connected with the shareholder's corporation who knows that a third party intends to make an offer for the shares at a higher price, is under no obligation to disclose this knowledge to the shareholder or to dissuade him from selling. This was clearly established by the Supreme Court in *Chiarella v. United States*.[18] *Chiarella* involved a printer who obtained information about pending takeover offers while working for the purchasing companies. When he used that information to trade in the stock of the target companies and reap a profit, he was charged with defrauding the investors from whom he purchased. The Supreme Court held this charge could not stand — the sellers were not defrauded since Chiarella was a stranger to them and owed them no fiduciary duty of disclosure. In the absence of a finding of fraud, the Court held, section 10(b) and Rule 10b-5 would not apply.[19]

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14. The author has made this point in previous publications. *See* Freeman, *'Insider Trading' v. 'Unfair Use'*, Nat'l L.J., June 13, 1983, at 15; Freeman, *Legislative Action Called "Desirable" for Resolution of Insider Trader Problems*, N.Y.L.J., Dec. 14, 1981, *reprinted in* 10 SEC '82. He has also made this point in testimony before the House subcommittee conducting hearings on H.R. 559.

15. *See* Freeman, *supra* note 14 and accompanying text.

16. This obligation is owed both the existing shareholders from whom the insider is buying and to potential shareholders to whom the insider is selling. *See* Chiarella v. United States, 445 U.S. 222, 227 n.8 (1980); Gratz v. Claughton, 187 F.2d 46, 49 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951).

17. *See, e.g.*, Strong v. Repide, 213 U.S. 419 (1909). This principle was recognized by the state courts as early as 1903. *See* Oliver v. Oliver, 118 Ga. 362, 45 S.E. 232 (1903); Stewart v. Harris, 69 Kan. 498, 77 P. 277 (1904).

18. 445 U.S. 222, 231-35 (1980).

19. *Id.* at 234-35. Following *Chiarella*, the SEC attempted to cover the situation presented in that case by promulgating Rule 14e-3, 17 C.F.R. § 240.14e-3 (1983), which

The same principle — that, absent such a fiduciary obligation, Rule 10b-5 does not prohibit trading on nonpublic information — was reaffirmed by the Court this past term in *Dirks v. S.E.C.*[20] In *Dirks*, the Court reversed an SEC administrative censure issued against a stock analyst who, in the course of his work, learned about massive fraud at an insurance company from former employees at the company.[21] The analyst told a number of people in the investment community about his findings, some of whom subsequently sold their stock in the company. The SEC charged the analyst with aiding and abetting violations of Rule 10b-5 by causing these persons to trade on nonpublic material information.[22] In reversing the censure, the Court found that the information was not public, and assumed that it was material.[23] The Court held, however, that the analyst was an outsider of the company who owed no duty of disclosure to company shareholders. In the absence of any such duty, the Court held, there could be no fraud on the shareholders and no violation of Rule 10b-5.[24]

As was to be expected, the government has not willingly accepted the repeated judgments of the Supreme Court and is now seeking to avoid them by ingenious legal theories which may, in certain courts and for a period of time, be at least partially successful. For example, in *United States v. Newman*[25] the government has successfully prosecuted a stock trader who was in exactly the same position as Chiarella, trading stock in companies that were the targets of tender offers. Like Chiarella, the stock trader learned of the tender offers indirectly from an investment house working for the companies planning the takeovers.[26] And,

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expressly prohibits trading on any nonpublic information concerning tender offers. The problem with this approach is that section 14(e) of the Securities Exchange Act, 15 U.S.C. § 78n(e) (1981), under which Rule 14e-3 was promulgated, is modeled on section 10(b) and, like that section, should probably only be read to prohibit acts which amount to fraud. Thus, Rule 14e-3 may well be no more applicable to outsider trading situations than Rule 10b-5 is.

20. 103 S. Ct. 3255 (1983).

21. *Id.* at 3250.

22. *Id.* at 3259.

23. *Id.* at 3260-61.

24. *Id.*

25. 664 F.2d 12 (2d Cir. 1981), *aff'd after remand*, No. 82-1273 slip op. (2d Cir. Feb. 8, 1983), *cert. denied*, 52 U.S.L.W. 3266 (U.S. Oct. 4, 1983) (No. 82-1653).

26. *Id.* at 15.

like Chiarella, the trader did not owe any fiduciary duties of disclosure to the shareholders of the target companies.[27] The conviction was achieved nonetheless by an instruction to the jury that they need not consider whether any investor was defrauded, but could find the defendant guilty if the information had been obtained or used in violation of duties of confidentiality owed to the investment house.

An even more unusual approach was proposed by the SEC, and adopted by the federal district court in California, in *S.E.C. v. Lund*.[28] That case involved an individual who was approached by the president of a company with an offer to participate in a joint venture which the company was planning with a third party. Although Lund did not join in the venture, he did purchase stock in the company, reaping a profit after the joint venture was announced.[29] In finding Lund liable under Rule 10b-5, the court held that although Lund was not an officer, director, or employee of the company, he became, simply by receiving nonpublic information about the company, a "temporary insider" of the company.[30] This theory is at best problematic. The court cited as authority a footnote in *Dirks* in which the Supreme Court noted that certain outsiders who "have entered into a special confidential relationship in the conduct of the business of the [company]" may acquire the same duties insiders have.[31] But that footnote only stated that certain persons — such as "an underwriter, accountant, lawyer, or consultant working for the corporation" — might become subject to an insider's duties as a result of being retained by a corporation.[32] There was

27. That the trader owed no duty to the shareholders was affirmed in a related civil suit brought by the shareholders under Rule 10b-5. Moss v. Morgan Stanley, [Current] Fed. Sec. L. Rep. (CCH) ¶ 99,478 (2d Cir. 1983).

28. [Current] Fed. Sec. L. Rep. (CCH) ¶ 99,495 (C.D. Cal. 1983).

29. *Id.* at 96,872.

30. *Id.* at 96,874. The Commission had originally pressed the theory that Lund was a "tippee" of a corporate insider, since he had received information about the venture from the company's president. In the wake of *Dirks*, however, the Commission abandoned that theory since it was apparent that the president had breached no duty in disclosing this information to Lund during legitimate business discussions. Under *Dirks*, finding of such a breach would be a predicate to finding "tippee" liability. *Id.* at 96,873.

31. *Id.* at 98,874 (quoting Dirks v. S.E.C., 103 S. Ct. at 3261 n.14).

32. Dirks v. S.E.C., 103 S. Ct. at 3261 n.14. The footnote is in fact adopted from a part of the argument of Dirks' counsel in the Supreme Court. *Cf.* Brief for Appellant at 31-34, Dirks v. S.E.C., 103 S. Ct. 3255 (1983).

absolutely nothing to suggest that a person who was not retained by the firm, and who acquired information in arms-length discussions about a possible business transaction, became a common law fiduciary towards the company with which he was negotiating.[33] Indeed, it is hard to see how such a duty can be conjured up out of *Dirks* in light of the Court's favorable reading of the Second Circuit's decision in *Walton v. Morgan Stanley & Co.*[34] In *Walton*, an investment banking firm, on behalf of a client, approached a corporation viewed by its clients as a possible takeover target. In the course of discussions with the target, the firm acquired confidential earnings figures. The investment banking firm traded on the information, reaping a profit when the figures were disclosed.[35] As the *Dirks* Court noted with approval, the firm did not acquire fiduciary duties simply because it acquired confidential information from a company in an arms-length negotiation with the company.[36] Yet based on nothing more than the fact that Lund acquired confidential information in an arms-length business discussion with a company's president, the *Lund* court found that he *did* acquire fiduciary duties.[37]

III. Analysis and Recommendations

The Commission may, of course, continue to be successful in pressing such theories. It is suggested here that whether or not the Commission is successful in partially circumventing the *Chiarella v. United States*[38] and *Dirks v. S.E.C.*[39] cases, it is

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33. The court in *Lund* suggested that it was sufficient that Lund acquired this information because he was a longtime friend and business associate of the president of the company. This, the court said, gave him a "special relationship" with the company. S.E.C. v. Lund, [Current] Fed. Sec. L. Rep. (CCH) ¶ 99,495, at 96,874. But it is clear that Lund was not given this information as a favor from a friend — if that had been the case he would be a "tippee" under *Dirks*. *See* Dirks v. S.E.C., 103 S. Ct. at 3265. And while Lund, as a likely business partner, did enjoy special access to information about the joint venture that other investors did not enjoy, that is insufficient to establish a duty under Rule 10b-5. Just such a "special access" rule was proposed by the dissenters in Chiarella v. United States, 445 U.S. at 251 (Blackmun, J., dissenting), and rejected by the majority in that case. *Id.* at 230.

34. 623 F.2d 796 (2d Cir. 1980).

35. *Id.* at 797.

36. Dirks v. S.E.C., 103 S. Ct. at 3265 n.22.

37. S.E.C. v. Lund, [Current] Fed. Sec. L. Rep. (CCH) ¶99,495, at 96,874.

38. 445 U.S. 222 (1980).

pursuing a myopic and unnecessarily restrictive course in attempting to do so. It also faces years of litigation, with the outcome uncertain, by trying to fit the conduct of such outsiders into a fraud mold. The SEC is so accustomed to the use of Rule 10b-5 as a be-all and end-all that it has not adequately recognized that the problem it is facing is of a different character, larger than can readily be managed within that narrow compass. There is an easier answer, as I have repeatedly pointed out:[40] specific legislation addressed to the problem of outsider trading.

For the problem the Commission faces today is a result of the proliferation of tender offers by outsiders and the creation of an option market in which the traders are not insiders and owe no fiduciary obligation to shareholders. Accordingly, the problem is not one that can be handled within the scope of a standard and a rule designed to protect the individual from fraud.

Instead, the concern the Commission does have and should have is that persons unfairly using information about coming events, such as tender offers, are engaged in socially unacceptable and publicly condemned conduct. For example, Chiarella's counsel did not seek to defend the morality of his actions even in the Supreme Court, but contended successfully only that it was not covered by the anti-fraud Rule designed to protect investors. Similar condemnation of the conduct of Chiarella was voiced by almost all members of the Supreme Court in that case, the majority and dissenters alike.[41] In the legislative considerations of the SEC-endorsed insider trading sanctions Bill, the Congressional Committee joined in the broad condemnation of the kind of conduct involved there. Indeed it was one of the members of the committee who suggested the analogy used above to playing with marked cards.[42]

In other words, Congress and the courts are sufficiently of-

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39. 103 S. Ct. 3255 (1983).

40. *See supra* note 14.

41. All members of the Court implicitly recognized that Chiarella's conduct was "unfair." Chiarella v. United States, 445 U.S. at 232, 241, 252 (1980).

42. *See Hearings, supra* note 13, at 66-67 (remarks of Jim Bates, member of Comm. on Energy & Commerce). Industry witnesses were concerned with other problems. Nevertheless they endorsed the suggestion presented by the writer that a new and separate bill be adopted outlawing the kind of conduct in which Chiarella engaged, independent of any concept of fraud.

fended by this type of conduct that they would consider adopting a standard outlawing outsider trading involving unfair uses of information without limiting the enforcing agency to a fraud concept. This standard could outlaw purchases of securities or options trading or any other means which allow persons in possession of this unfair advantage to make money as Chiarella did.

Such legislation would be easily adopted if supported on an institutional basis. If the SEC were to make such a suggestion, there would be no difficulty in having it promptly adopted by both houses of the Congress, since there is no constituency opposed to legislation outlawing unfair use of information in the markets.

Problems about the precise definition and scope of such a law would have to be addressed, but these issues should be easily resolved. The SEC is in a position to take the leading role and to secure congressional approval for which it would and should get credit.

To date, it has been reluctant to take this initiative and has not accepted the suggestion for such legislation which the writer put forth in testimony on H.R. 559.[43] However, the setback that the Commission has since received in the decision against it by the Supreme Court in the *Dirks* case has caused it to reconsider. There is a reasonable possibility that it may, after such reconsideration, seek to introduce and support legislation to this end. If it does so, it will meet no opposition in the Congress or in the financial industry, and it will be welcomed by the courts which are outraged by the immoral conduct involved, but have not yet been given the tools to deal with it. Such legislation could be readily adopted as stated.

43. *Hearings*, *supra* note 13, at 159-60.

A BILL

To amend the Securities Exchange Act of 1934
to make unlawful unfair use of information in trading

BE IT ENACTED BY THE SENATE AND HOUSE OF REPRESENTATIVES OF THE UNITED STATES OF AMERICA IN CONGRESS ASSEMBLED, Section 16(f). To Make Unlawful Unfair Use of Information.

(a) It shall be unlawful for any person who is in possession of material nonpublic information of such a character as may reasonably be expected immediately upon disclosure substantially to affect the price of the securities of such issuer to profit from such information or avoid loss by purchasing or selling such securities or any securities, convertible into or exchangeable for such securities or options or rights to obtain or dispose of such securities, or to aid and abet any such person so to profit or avoid loss, if he employs the information in violation of his own fiduciary or contractual obligations, or if to his knowledge the information is imparted to him in violation of the fiduciary or contractual obligations of the person imparting such information to him.

(b) Notwithstanding anything in paragraph (a) to the contrary, the following transactions shall not be in violations of paragraph (a) of this section:

(1) Purchases of any security described in paragraph (a) by a broker or by another agent on behalf of an offering person; or

(2) Sales by any person of any security described in paragraph (a) to the offering person.

(c) No person shall be subject to a sanction under subsection (a) of this section solely because that person aided and abetted a transaction covered by it in a manner other than by communicating material nonpublic information. Section 20 of this title shall not apply to actions brought under subsection (a) of this section. No person shall be liable under subsection (a) of this section solely by reason of employing another person who is liable under such subsection.

A person other than a natural person that employs another person who is liable under subsection (a) of this section shall not be liable if such person shows that:

(1) The individual making the investment decision on behalf of such person to purchase or sell any security described in subsection (a) did not know the material, nonpublic information; o:

(2) Such person had implemented one or a combination of policies and procedures, reasonable under the circumstances, taking into consideration the nature of the person's business, to ensure that individual(s) making investment decision(s) would not violate subsection (a), which policies and procedures may

include, but are not limited to, (i) those which restrict any purchase, sale of any such security or (ii) those which prevent such individual(s) from knowing such information.

(d) It shall not be necessary to establish a violation of this Section 16(f) that the acts made unlawful be proved to be done with any purpose to deceive, manipulate or defraud investors but only that the use of information was unfair as violating an express or implied obligation.

(e) Any person violating this section shall forfeit the amount of the profit gained or the loss avoided and shall pay an amount determined by the court in light of the facts and circumstances up to three times the amount of the profit gained or the loss avoided into the Treasury of the United States upon order of a United States District Court in an action commenced by the Commission under Section 21(a).

For purposes of this paragraph "profit gained" or "loss avoided" is the difference between the purchase or sale price of the security and the value of that security as measured by the trading price of the security a reasonable period after public dissemination of the nonpublic information.

(f) This section is in addition to any other provision of law and particularly, shall not be deemed in any way to restrict the scope of Section 10(b) and 14(e) of this Act and the rules promulgated thereund

Senator D'AMATO. Mr. Brodsky, I understand you have a time problem.

STATEMENT OF DAVID M. BRODSKY, ESQ., CHAIRMAN, AMERICAN BAR ASSOCIATION, SECTION OF LITIGATION, SUBCOMMITTEE ON SEC ENFORCEMENT PROCEDURES

Mr. BRODSKY. Thank you, Senator. I appreciate very much the opportunity to follow Mr. Freeman so I can get back to court in New York City.

I am David M. Brodsky, a member of the firm of Schulte, Roth & Zabel, and a member of the bars of the State of New York and the District of Columbia.

I am pleased and honored to have been asked by Senator D'Amato to appear today to testify on H.R. 559 as well on his proposal.

I wish to emphasize at the outset that I am speaking in my individual capacity today and although I serve as chairman of an ABA subcommittee on SEC enforcement procedures, I do not speak today in any role except as an individual.

I will say, however, that members of the litigation section council have received a copy of your proposed bill and there is great interest in the litigation section council of the ABA and very great——

Senator D'AMATO. Consternation?

Mr. BRODSKY. No—very great interest, and they may well authorize a spokesperson to come before this subcommittee or the committee as a whole and submit either oral or written statements about the proposal.

My only request today on behalf of the litigation section is that we be given an adequate amount of time to consider it; personally, I think it's both a novel approach and a very much needed one; I will keep Neal Levin informed as to our progress.

In the limited time I have available I want to make two comments about the insider trading bill as it comes over from the House and then I want to address some comments to you, Senator, on your bill.

TWO PROBLEMS THAT NEED TO BE DEALT WITH

The Insider Trading Sanctions Act has two problems that have to be dealt with when this committee is going to take it up. Despite the fact that the act does contain language designed to limit the scope of secondary liability, I believe the scope of the limitation is, as presently drafted, confusing and ambiguous. As a starting point, I believe that treble damage sanctions are so severe that they should be imposed only when the person being sanctioned has actually himself traded or communicated material nonpublic information to others who traded at a time when they knew or had reason to know the information was nonpublic and when such information was being communicated under circumstances involving a breach of fiduciary duty. The present section 2B was drafted at the specific suggestion of the Commission. Chairman Shad wrote a letter on June 29, 1983 to Congressman Wirth with the language and that was picked up by the House side.

The law of aiding and abetting is murky enough as it is and especially to a prosecutor, as I once was, and a defense attorney, as I now sometimes am, it could encompass very nebulous acts including making a phone call, writing letters, even making purchase or sale recommendations in good faith, and it seems to me that the Commission could easily take such acts and allege they take the conduct out of the safe harbor of section 2B. From a law enforcement perspective as well as from a defense point of view, it would seem to be desirable to define the specific acts of trading and tipping which would constitute the aiding and abetting.

My colleague, Mr. Jacobs, has already submitted to the committee a section which I think very adequately deals with that problem.

Mr. BRODSKY. With respect to the issue of definition, I have a tremendous amount of respect and admire both John Fedders and Dan Goelzer and their staffs and I'm glad to know that they have personally attempted to draft the elusive definition of insider trading. I am disappointed at this point they feel that no definition is possible to come up with or that it's extremely difficult to do so.

To my knowledge, few if any persons outside the Commission have actually seen the definition and Dan Goelzer spoke a few weeks ago to the SIA, the Securities Industry Association, in New York and referred to a more than one page definition. It would be helpful to the general debate if the Commission authorized them to release the draft to not only this committee but also to members of the bar association committees who are actively involved in this so we can all take a shot at it and maybe we could tinker with it and possibly improve it.

But I think that Mr. Fedders' testimony today illustrates that the real problem with the definition is that there are many forms of trading which appear to involve unfair use of nonpublic information or not yet public information. But the Supreme Court has made it clear in both *Chiarella* and *Dirks* that neither unfairness nor theories of open access to market information is alone a basis for finding fraudulent conduct.

Senator D'AMATO. Under the present law?

Mr. BRODSKY. Under the present law.

Senator D'AMATO. It doesn't really say that the conduct may not be fraudulent or that the conduct itself, but under the present law?

Mr. BRODSKY. Well, that's the key point. You put your finger right on the problem. You always have to go back to finding fraud because that was what rule 10b-5 was designed to rule out.

Senator D'AMATO. So you've got the printer who comes and undertakes an act that I think everybody can agree with breaks every standard of law that we would go by, steals the information, profits by it, but under the law he cannot be prosecuted; is that correct?

Mr. BRODSKY. There are several theories under which he could have been prosecuted. The U.S. attorney chose to prosecute him on one theory which the Supreme Court rejected and as John Fedders indicated, if other theories had been advanced like the misappropriation theory on which other people had been indicted and con-

victed, and indeed Mr. Newman who was indicted on the alternate theory in fact went to jail. I think he may be one of the only people who actually went to jail for insider trading that I'm aware of, but there are people who go to jail for these things now.

My point is that the SEC continues to attempt to crack down in cases where we can all agree it's unfair what's happening, but what we can't all agree on is that what's happening is classic rule 10b–5 fraud, the kind of fraud that Mr. Freeman had in mind when he participated in drafting rule 10b–5 in the 1940's.

The printer who deciphers market information—sure, he's engaging in something that's unfair. The registered representative——

Senator D'AMATO. Question. You miss the issue. Should we not prevent that kind of conduct and make that kind of conduct clearly illegal?

Mr. BRODSKY. My testimony today is that we absolutely should.

Senator D'AMATO. We should.

Mr. BRODSKY. Yes. I strongly support your attempts to put into words the concept of breaching fiduciary duties or contractual obligations, taking them out of the context of——

TAKING IT OUT OF CONTEXT OF FRAUD

Senator D'AMATO. Or stealing information?

Mr. BRODSKY. Or misappropriating information, but taking them out of the context of fraud because fraud has certain meanings which require, unfortunately, the courts, to go through mental gymnastics to find rule 10b–5 fraud, whereas if you drafted something that took it out of the context of fraud, as Mr. Freeman has done, as your counsel has done, as you have done, then we're dealing with a different concept that's much easier to apply and we embrace perhaps broader conduct of unfair use of information rather than fraudulent use of information.

If you look at insider trading in its classic sense, trading on confidential information from and about an issuer by a person owing fiduciary duties to the issuer and its shareholders, then it is possible to draft a short and concise definition of the conduct. The problem is that that does not encompass all other possible conduct that we find abhorrent. The Supreme Court did say in *Chiarella* that "not every instance of financial unfairness constitutes fraudulent activity under rule 10b–5." The good point of this proposed legislation is that if you prohibit misuse of confidential information by persons who violate duties, contractual or fiduciary, and they use such information, then you're dealing with a very viable and understandable concept.

The proposal strikes a balance it seems to me between the problems created by an excessively cluttered definition, which is what John Fedders is really talking about in the context of rule 10b–5, and the problems which might be created by simply shrinking the definition to classic financial fraud which then leaves a whole world of possibilities open, through which, as was referred to by you, Senator, one could drive a truck.

There are only three aspects of the proposal that I've had time to study which trouble me. One is that the exclusion in subsection (c) carries over the language on aiding and abetting from the House

bill and I believe it should be similarly amended to define specific conduct.

Senator D'AMATO. You don't think our exemption adequately covers that?

Mr. BRODSKY. I think we should deal specifically with people who trade on information or communicate nonpublic information knowing that they are doing so in breach of duties. I think the way the exemption is now phrased is ambiguous and would lead to some further problems. It uses, for example, words like "aiding and abetting" which seems to me opens up the whole problem of what is aiding and abetting, again a definitional problem. I think something can be drafted, the Senate can draft something, which handles the problem of what kind of conduct we are trying to prohibit.

Second, I personally feel that subsection (d) unnecessarily attempts to clarify that section 16(f) is not fraud-based. It explicitly introduces the concept of "unfair use." Again, these are words of such breadth and ambiguity as to allow both the Commission and the courts very unreasonable latitude. I would simply urge that subsection (d) be deleted.

Finally, I think that the proposal ought to deal squarely with the concept of private rights of action. Last year, when I was privileged to testify on the House side before Congressman Wirth's subcommittee, I testified in response to his question that the bill should not deal with the issue of private rights of action because I felt the bill was being dealt with as an adjunct to rule 10b–5 and we would simply pick up the law and apply benefits as the courts have evolved them.

But if this subcommittee is going to consider an amendment to section 16 as you propose, I feel the bill should include a provision that there shall be no private rights of action created or construed to exist under the amended 16. I look forward to returning to the subcommittee shortly with the position of the full litigation section and on a personal level I thank you very much for allowing me to appear and I stand ready to assist the subcommittee in any way that you think might be helpful.

Senator D'AMATO. Thank you very much for your help.

[The complete statement follows:]

STATEMENT TO SECURITIES SUBCOMMITTEE
OF THE UNITED STATES SENATE BANKING,
HOUSING AND URBAN AFFAIRS COMMITTEE
April 3, 1984

Senator D'Amato, Senator Sarbanes, and other distinguished members of this Panel:

My name is David M. Brodsky, a member of the New York City law firm of Schulte Roth & Zabel, and a member of the Bars of the State of New York and of the District of Columbia.

I am pleased and honored to have been asked to give my views on H.R. 559, the Insider Trading Sanctions Act of 1983, as well as on Senator D'Amato's proposed Bill to amend Section 16 of the 1934 Exchange Act to add a new section 16(f) dealing with unfair use of material nonpublic information.

I wish to emphasize at the outset that my appearance today is strictly in my individual capacity and that, although I serve as Chairman of an American Bar Association Litigation Section Subcommittee on S.E.C. Enforcement Procedures, I do not speak today in any role except as an individual. I am not today authorized to speak for any segment of the A.B.A. I will add, however, that the Securities Litigation Committee, of which my subcommittee is a part, has initiated steps to bring Senator D'Amato's proposal before the Litigation Section Council so that at a time in the near future, that important Section of the A.B.A. may

well authorize a spokesperson to testify or submit written statements regarding the proposal. My request today on behalf of the Securities Litigation Committee is that, before this subcommittee or the Senate's full committee on Banking, Housing and Urban Affairs acts on Senator D'Amato's proposal, the Litigation Section be heard on the issues which it presents. I will continue to keep Neil Levin, Counsel to this subcommittee, informed as to the Litigation Section's consideration, if you would like me to do so.

In the limited oral time that I have available to me, I wish to address the following subjects:

First, the Insider Trading Sanctions Act and the need for additional protections involving secondary liability and a definition of insider trading; and

Second, the proposed amendment of section 16 which contains a radically new concept in the law of insider trading which I personally favor, namely the elimination of a fraud-based concept for insider trading and the substitution of a flat prohibition against most forms of insider trading.

Despite the fact that the Act does contain language designed to limit the scope of secondary liability, the scope of the limitation is, as presently drafted, confusing and ambiguous. As a starting point, I believe that treble damage sanctions are so severe that they should be imposed only when the person being sanctioned has actually

traded or communicated material nonpublic information to others who traded at a time when the tippers and traders knew or had reason to know the information was nonpublic and was being communicated under circumstances involving a breach of fiduciary duty. The present section 2B was drafted at the specific suggestion of the Commission (see letter of John Shad to Congressman Wirth, June 29, 1983) and would allow for treble damages to be imposed for aider and abetter activity, the exception being that one could not be held liable if the person's sole conduct was to aid and abet "in a manner other than by communicating material nonpublic information."

But the law of aiding and abetting is murky, and could encompass such nebulous acts as making a telephone call, writing a letter, or on good faith making a stock recommendation; the Commission could easily allege that such acts took the actor's conduct out of the safe harbor of the exception referred to. From a law enforcement perspective as well as from a defense point of view, it would seem far more preferable to define the specific acts of trading and tipping which would constitute the unlawful activity than to leave the law unsettled with the possibility of treble damage sanctions as a penalty.

In my written submission, which I will submit next week, I have proposed some specific language changes to the Act to deal with these ambiguities.

With respect to the issue of a definition, I respect and admire John Fedders and Dan Goelzer and their staffs and am glad to know that they have personally attempted to draft a definition of the elusive concept of "insider trading". I am disappointed that they feel that such definition is too complicated to be included in the Act.

I remain unconvinced that a definition of insider trading, which the Commission still opposes, is not possible.

First, to my knowledge, few, if any, persons outside the Commission have seen the more than one page definition which has been referred to by Messrs. Fedders and Goelzer. It would be helpful to the general debate if the Commission would authorize them to release the draft so others could tinker with -- and possibly improve -- it.

Second, the entire problem with a definition is that insider trading has come to mean many things to many people:

- The printer who deciphers market sensitive information about takeover target companies and trades on such information does not defraud such companies' shareholders in the classic sense of fraud, but the S.E.C. has undoubtedly wanted to include such unseemly conduct in a definition. My view is that such an attempt would be misplaced. Not every misuse of market sensitive information should be a

violation of the fraud provisions of the securities laws.

- The registered representative of an investment banking firm engaged on behalf of a proposed tender offeror, who misuses confidential information by purchasing securities in the proposed target company, has not breached duties owed to the shareholders of the target company. But such representative has, in the words of the Second Circuit, "sullied" the firm's reputation and, accordingly, violated fiduciary duties to such banker. My own view is that such conduct in no way should be deemed a violation of Rule 10b-5, civil or criminal. But, once again, presumably the S.E.C. would want to include the tremendously varied fact patterns involving banking firms' reputations within a definition. I am unpersuaded that all such fact patterns should be covered by a definition.

My point is that if one looks at insider trading in its classic sense -- trading on confidential information from and about an issuer by a person owing fiduciary duties to the issuer and its shareholders -- then it is possible to draft a short and concise definition of the conduct, always focussing on the fact that the definition must have its roots squarely in the soil of Section 10b and Rule 10b-5 fraud language.

But many of the legal problems and judicial gymnastics in the developing law of insider trading have arisen precisely because presently the concept must be grounded in fraud to violate 10b-5. To fit the myriad of situations which the Commission wishes to crack down on in this area, the word "fraud" has become the all-purpose stretch word in the S.E.C. lexicon; as such, it has ceased to have a firm meaning or to fit fact patterns which one normally associates with fraud. The result is that courts resist imposing criminal or civil liability in situations which strike us as crying out for some remedy. For example, Vincent Chiarella's indictment was dismissed because the Supreme Court found that "not every instance of financial unfairness constitutes fraudulent activity under 10(b)." 445 U.S. 222 at 232 (1980).

In my view, the answer to this problem is flatly to prohibit misuse of confidential information by categories of persons who violate fiduciary or contractual duties. That answer has now been provided by Senator D'Amato's proposal, which would make unlawful trading or tipping by a person who employs material nonpublic information in violation of contractual or fiduciary obligations.

There are three aspects of the bill as I have seen it which trouble me at this time:

First, the exclusion in subsection (c) carries over the language on aiding and abetting from H.R. 559. I

believe it should similarly be amended to define the specific conduct being prohibited, as I will attempt to do in my formal submission.

Second, subsection (d), in my view, unnecessarily attempts to clarify that the new section (f) is not fraud-based. Such attempt is redundant and potentially troublesome to a court because it explicitly introduces the concept of "unfair use", which are words of such breadth and ambiguity as to allow both the Commission and the Courts tremendous and, I think, unreasonable latitude. I would urge that subsection (d) simply be deleted.

Third, the proposal ought to deal squarely with the concept of private rights of action. Last year, when the hearings on the Insider Trading Sanctions Act were held by Congressman Wirth's subcommittee, I testified that the Bill should not deal with the issue of private rights of action, because I felt that the Bill, as an adjunct to Section 10b and Rule 10b-5, would pick up the law of implied remedies under those sections.

But if this subcommittee is going to consider amending Section 16, as Senator D'Amato proposes, I feel the Bill should include a provision that there shall be no private rights of action created or construed to exist under the amended Section 16(f).

Thank you for hearing my views.

The New York Times

NEW YORK, SUNDAY, MAY 8, 1983

Business Forum

THE WAR AGAINST 'INSIDER TRADING'

A Good Definition Might Help

By DAVID M. BRODSKY

THE Securities and Exchange Commission has declared war on insider trading. It has submitted to Congress a bill — the Insider Trading Sanctions Act of 1983 — designed to help win what has been called an "unwinnable war." But, unless the strategy is modified, it may create worse problems than exist even now.

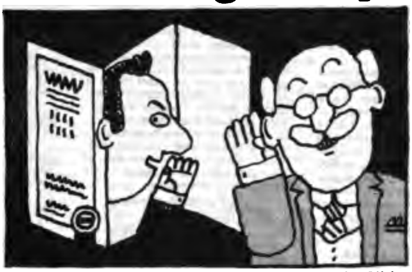
The increased visibility which the S.E.C. has given to insider trading in the last few years has created an angry mood in Congress. And in recent hearings on the bill before the House Subcommittee on Telecommunications, Consumer Protection and Finance, the chairman, Timothy Wirth, Democrat of Colorado, said, "We must provide a sufficient deterrent so that people will think twice before they engage in what all of us would call thievery."

The bill proposed by the S.E.C. would, among other things, allow the commission to impose civil penalties of up to three times the amount of the insider's illegal profits or avoided losses. Currently, the only civil sanctions against violators are repayment of the wrongfully derived profits and entry of a permanent injunction.

The goal of the commission and of Congress is certainly laudable. There is little doubt that the rewards of insider trading — transactions made on the basis on nonpublic information that can affect the price of a company's stock — have grown tremendously over the past few years, the result of a great surge in mergers and tender offers as well as the growth of options trading. And there is certainly a consensus that the traditional remedies are ill-suited to deter the wave of illegal trading. At issue, however, is the means best suited to accomplish this task.

The underlying concern shared by all participants in this debate is how best to protect the integrity of the securities market. Supporters of the legislation feel — and rightly so — that the threat of insider trading erodes investor confidence in the market; but no one seriously believes that insider trading abuses will cause investors to abandon the market, or will severely affect the market's liquidity.

David M. Brodsky is chairman of the American Bar Association's litigation section subcommittee on S.E.C. enforcement and is a partner in the New York law firm of Schulte Roth & Zabel. The views expressed here are his own.



Stuart Goldenberg

The problem, then, must be put in perspective. A thoughtful and balanced solution must be found, and certainly increasing the enforcement powers of the S.E.C. — the main provision of the proposed bill — is among the possible solutions. The great irony in the bill, however, is that it may actually impede the ability of the S.E.C. to enforce the law and it could potentially cause harm to the securities markets themselves.

In my testimony before the House Subcommittee last month, I pointed out that the flaw in the proposed legislation is that while it seeks to change the law by stiffening penalties for insider trading, it fails to provide a definition of what this violation is. Rule 10B-5, the principal antifraud statute, proscribes fraudulent conduct in the purchase and sale of securities, but nowhere does it spell out who is not allowed to trade on confidential corporate or market information, or what kind of conduct is fraudulent. As a result, there is now great confusion in the courts and in the public eye about what insider trading actually is.

On certain points, there is little debate. The president of a publicly traded company who learns at a board meeting of a major oil strike by his corporation and leaves the meeting to buy shares of company stock before the news is made public, has committed a classic violation of Rule 10B-5. And most would also agree that a person overhearing a conversation in the street between two others about a similar corporate development, not knowing who the participants are, not having any relationships to any of the companies mentioned, who then acts on the conversation by buying stock, has committed no illegal act.

THERE is a vast gray area between these two extremes and this has caused several courts to go through mental gymnastics to find "fraud" under rule 10B-5.

To incorporate a definition of insider trading into the proposed legislation would not weaken the bill, as many have argued. It would strengthen it. It would clarify a confusing point of law, and in so doing, it would expedite the S.E.C.'s enforcement procedures.

The current ambiguity in the law, however, is not only a thorn in the side of the S.E.C.; since the bill would add stiffer sanctions for insider trading against those who actually trade as well as those who assist them, the vagueness of the law poses a threat to securities institutions and to the efficiency of market pricing.

The efficiency of market pricing is only possible in a well-informed marketplace. Securities analysts fulfill this function by actively seeking out corporate information on behalf of their clients. A few years ago, the S.E.C. itself recognized the importance of this contribution:

"Analysts actively seek out bits and pieces of corporate information not generally known to the market for the express purpose of analyzing that information and informing their clients who, in turn, can be expected to trade on the basis of the information conveyed. The value to the entire market of these efforts cannot be gainsaid . . . the analyst's work redounds to the benefit of all investors."

Yet, despite such comments, the S.E.C. went on in that case to find that Raymond Dirks, a securities analyst, violated 10B-5 when he told his clients about a huge fraud at Equity Funding, which he had learned from a disgruntled employee. There was concededly no special financial arrangement between Mr. Dirks and the employee of the company, and it is noteworthy that when Mr. Dirks appealed the case, the Justice Department came out on his side. Under the proposed bill, Mr. Dirks would be liable for up to three times the avoided loss of each of his clients who acted on his advice to sell — a sum that could total in the hundreds of millions of dollars.

Thus, an ambiguous flaw, which threatens with draconian penalties securities analysts who pursue, for completely legitimate purposes, corporate information may have the undesirable effect of making inefficient the entire system of market pricing.

The S.E.C. may, however, be coming around to the view that it is necessary to define who exactly is liable under the proposed bill. At the April 13 hearings, the S.E.C.'s chairman, John S. R. Shad, and the director of enforcement, John Fedders, indicated that they would consider redrafting the bill so as to include a definition. And such a definition is apparently being drafted by the S.E.C. staff. But there is still strong opposition in the House to any changes in the bill. Both Representatives Wirth and John Dingell, Democrat of Michigan, who introduced the legislation, have gone on record as saying that they are against any revisions. They argue that a definition would allow sophisticated defense lawyers to create loopholes for further fraudulent conduct.

Clearly the efforts of the two Congressmen are proceeding in exactly the wrong direction. The war against insider trading may or may not be winnable, but the chances for victory should not inadvertently be sabotaged by failing to include a definition specific enough to make the bill truly effective. ■

New York Law Journal

NEW YORK, THURSDAY, APRIL 28, 1983

Some Clarification Needed On Who Is an 'Inside Trader'

By David M. Brodsky

I am pleased and honored to have been asked to testify here today on H.R. 559, the proposed Insider Trading Sanctions Act of 1983, and on certain other proposals regarding additional sanctions to be added to the SEC arsenal against securities law violators.

At the outset, let me state that I am speaking today in my individual capacity only and not as a spokesperson or representative of any bar association group. I have studied the proposed legislation and written about it in my capacity as chairman of a Subcommittee on SEC Enforcement Procedures of the American Bar Association Litigation Section's Committee on Securities Litigation. However, I am not speaking on behalf of such committee, section or association, nor have I been authorized to do so by the ABA.

Former Prosecutor

My views on this legislation and the other proposals are shaped by my professional background as a former Assistant United States Attorney in the Southern District of New York, where I served for several years, in part in the Securities Fraud Unit, and for the past ten years as a defense attorney in many different kinds of securities matters initiated by the SEC, including several in the so-called insider trading area. During these years, I have gained a healthy respect for many attorneys from the SEC with whom I came in daily contact. From such experiences I have drawn a number of conclusions:

First, the SEC enforcement effort is now as alive and vigorous as ever, perhaps more so, and especially in the areas of securities trading abuses and broker-dealer problems — both of which go to the heart of the integrity of the marketplace, the SEC's primary concern.

Second, there is a healthy debate underway as to the scope of SEC enforcement powers, due process rights to individuals and corporations under investigation, and the need for more power to the SEC to beef up its enforcement arsenal. This debate appears currently to be focused on issues as to specific cases about which I know very little. It seems more appropriate from my perspective as a defense attorney that the debate be focused on the way in which the SEC can better do the immensely complicated enforcement job it has before it, without upsetting the rights of those under investigation, some of whom at least have not violated the securities laws. To the extent that testimony today and later assists you to focus on that aspect, I — and I assume my colleagues — believe we will have contributed something to this process.

With respect to the specific bill introduced by Congressmen Dingel and Wirth, I do not share the view expressed by others on this panel that it is not needed. To the contrary, I think it is important that "insider trading," and I will come in a moment to what I think that term means, be separately dealt with from other examples of so-called "fraud" under Section 10(b) of the 1934 Act, and Rule 10b-5 promulgated thereunder.

> Mr. Brodsky is a member of the New York firm of Schulte Roth & Zabel. This article is a statement made by him at recent hearings by the House Subcommittee on Telecommunications, Consumer Protection, and Finance, on proposed legislation to stiffen sanctions for insider trade violations.

Concept of 'Insider Trading'

The concept of what is "insider trading" is now so confused in the courts and in the public's mind that the strong deterrent effect of an action by the SEC under existing law is significantly diluted by a general misconception of what is actually proscribed and the resulting litigation and conflicting court interpretations of what is proscribed.

Obviously, at the extremes, there will be little debate that, on the one hand, the president of a publicly-traded company who learns at a board meeting of a major oil strike by his corporation and leaves the board meeting to buy shares of stock in his corporation before the news is made public has committed a classic violation of Rule 10b-5 by defrauding the selling shareholders of his company. For that violation, we need no additional statutory scheme to proscribe it.

On the other hand, I assume there will be little dissent that a person overhearing a conversation between two others about a possible tender offer in an elevator, street, or other public place, not knowing who the participants are, not having any relationships to any of the companies mentioned, who then acts on the conversation by buying stock of the target, has committed no act which should be deemed a violation of the federal securities laws. I assume also that most would agree that new legislation should not be drafted to proscribe this kind of conduct.

The vast problems exist in the middle, and they have caused the Supreme Court in *Chiarella* and the Court of Appeals for the Second Circuit in *Newman*, to go through mental gymnastics to find — some would say "invent" — fiduciary duties which were breached so a violation of Rule 10b-5 could be found.

The fact is that the concept of persons in possession of "material non-public information" is so all-encompassing a term as to sweep in many kinds of conduct which should not, in my view, be dealt with in the same way. See, in general, Fleischer, Mundeim, and Murphy, *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. Pa. L. Rev. 798 (1973).

Clarification Proposed

Thus, at a minimum, I believe the following should be made clear in the statute and in the legislative history as to the concept:

(1) It is meant to include persons whom I denominate as primary sources, who are in the employ of the issuer, or its agents, or other fiduciaries, or in the employ of other entities or persons who have the capacity to affect the market price of the issuer, and who receive and wilfully act upon non-public information.

(2) It is meant to include those persons who receive non-public information from such primary sources, knowing that such information is material and non-public, and who wilfully act upon it (so-called "tippees").

(3) The term is not meant to include those who casually or inadvertently come into possession of the non-public information, who have no relationship, through blood, employment, or agency, with either the issuer, its agents or fiduciaries, or those who have the capacity to affect market price, and who act upon it.

Issue of Damages

With respect to the issue of damages, I favor a fixed penalty amount and do not support the concept that the Court should have the discretion to impose a penalty "in light of the facts and circumstances." I believe that the essence of deterrence is predictability; fixing a penalty at a specific amount is far more of a deterrent than knowing that "facts and circumstances," highly ambiguous words, will be taken into account.

I urge support of a fixed double damage penalty modelled after the False Claims Act, Title 31 U.S.C. Secs. 231-233, 235. This Act provides that the United States may recover from a person who presents a false claim to it a forfeiture of $2,000 plus an amount equal to double the damages that it sustains by reason of the false claim. *See, United States v. Bornstein*, 423 U.S. 303, 305 (1976).

I also urge that the flexibility in assessing penalties which the SEC is apparently seeking, so as to encourage cooperation and consent judgments, be achieved by providing that the court can impose a lesser penalty if the SEC and a proposed defendant agree upon a settlement of proposed charges and of the proposed fine before the action is instituted. However, if the SEC is compelled to bring an action, the court should have no discretion and should be required to impose a double damage penalty, plus costs.

Standard of Proof

With respect to the issue of the standard of proof, the SEC's position that they be held only to a standard of "preponderance of the evidence" has recently been upheld by the Supreme Court in *Herman & MacLean v. Huddleston*, CCH Fed. Sec. L. Rep. Para. 99,058 (1983). But I do not believe that standard is appropriate in the context of a suit for multiple damages. *Huddleston* was an action for simple damages and is thus distinguishable.

Who Is an 'Inside Trader'?

continued

The False Claims Act, to which I referred earlier, has existed for over 100 years, and the general rule in that Act is that the Government must prove its case by clear and convincing evidence. This rule is supported by the great weight of authority. *E.g., United States v. Milton*, 602 F.2d 231, 233 (9th Cir. 1979) ("clear, explicit and unequivocal evidence"); *Hageny v. United States*, 570 F.2d 924, 933 (Ct. Claims 1978) ("clear and convincing" evidence); *United States v. Ekelman & Associates, Inc.*, 532 F.2d 545, 548 (6th Cir. 1976) ("clear, unequivocal and convincing evidence"); *United States v. Foster Wheeler Corp.*, 447 F.2d 100, 101 (2d Cir. 1971) ("clear and convincing" evidence); *United v. Lawson*, 522 F. Supp. 746, 749-50 (D.N.J. 1981) ("clear and convincing" evidence); *United States ex rel. Hughes v. Cook*, 498 F. Supp. 784, 787 (S.D. Miss. 1980) ("clear and convincing" evidence); *United States v. Aerodox, Inc.*, 327 F. Supp. 1027, 1033-34 (S.D. Fla. 1970) ("clear and convincing" evidence), *other parts rev'd on other grounds*, 469 F.2d 1003 (5th Cir. 1972); *United States v. Klein*, 230 F. Supp. 426, 432 (W.D. Pa. 1964) ("clear and convincing" evidence), *aff'd on opinion below*, 356 F.2d 983 (3d Cir. 1966); *United States v. Robbins*, 207 F. Supp. 799, 807-08 (D. Kans. 1962) ("clear, explicit and unequivocal evidence").

Trial by Jury

With respect to the right to a jury trial, an action to recover a statutory penalty generally carries the right to a jury trial. As Judge Friendly stated in *United States v. J.B. Williams Co.*, 498 F.2d 414 (2d Cir. 1974), "There can be no doubt that in general 'there is a right of jury trial when the United States sues . . . to collect a penalty even though the statute is silent on the right of jury trial'." *Id.* at 422-23 (quoting 5 Moore, Federal Practice Para. 38.31[1], at 38-235-36 (1982 ed.)). The court in *J.B. Williams* held that there was a right to jury trial in Government actions to recover civil penalties under Sec. 5(*l*) of the Federal Trades Commission Act, 15 U.S.C. Sec. 45(*l*).

In *Hepner v. United States*, 213 U.S. 103, 29 S. Ct. 474 (1909), the leading case in this area, the United States Supreme Court found a right to jury trial in an action brought by the United States to collect a penalty pursuant to the Alien Immigration Act. The Court held that in a civil action to recover a statutory penalty arising from the commission of a public offense, "[t]he defendant was, of course, entitled to have a jury summoned," although, as is fundamental in civil cases, the trial court may direct a verdict if the evidence is uncontradicted. 29 S. Ct. at 479. *See also, United States v. Regan*, 232 U.S. 37, 47, 34 S. Ct. 213, 216 (1914) (reaffirming that in an action to recover a penalty for an alleged violation of the Alien Immigration Act "the defendant was entitled to have the issues tried before a jury").

Following *Hepner*, the courts have repeatedly held there to be a right to a jury trial in actions by the Government to recover civil penalties under a wide range of statutes that contain no specific provision for jury trials. *See, e.g., Brown & Williamson Tobacco Corp. v. Engman*, 527 F.2d 1115, 1121 (2d Cir. 1975) (civil penalty under Sec. 5(*l*) of the Federal Trade Commission Act), *cert. denied*, 426 U.S. 911 (1976); *Connolly v. United States*, 149 F.2d 666, 669 (9th Cir. 1945) (civil penalty under 25 U.S.C. Sec. 179, pertaining to use of Indian land without permission); *Damsky v. Zavatt*, 289 F.2d 46 (2d Cir. 1961) (taxes, penalties and interest under various provisions of I.R.C.); *United States v. Open Bulk Carriers, Ltd.*, 46 F. Supp. 159, 166 (S.D. Ga. 1979) (civil penalties under Shipping Act); *United States v. Friedland*, 94 F. Supp. 721, 724 (D. Conn. 1950) (treble damages under Housing and Rent Act of 1947); *United States v. Jepson*, 90 F. Supp. 983 (D. N.J. 1950) (treble damages under Emergency Price Control Act of 1942); *United States ex rel. Rodriguez v. Weekly Publications, Inc.*, 9 F.R.D. 179, 181 (S.D.N.Y. 1949) (civil penalty and double damages under False Claims Act).

The rationale for these decisions is that suits for statutory penalties were recognized at common law as part of the action in debt. *See, e.g., Damsky v. Zavatt; United States v. Jepson, supra* (collecting common law cases). Accordingly, the right of trial by jury in these cases is protected by the Seventh Amendment to the Constitution, which provides in pertinent part that "in suits at common law, where the value in controversy shall exceed $20, the right of trial by jury shall be preserved."

The fact that the specific action is of modern, statutory origin does not deprive the defendants of jury trial. As the court observed in *Jepson, supra*,

". . . when a federal statute embraces a common-law form of action, that action does not lose its identity merely because it finds itself enmeshed in a statute. The right of trial by jury in an action for debt still prevails whatever modern name be applied to the action. To hold otherwise would be to open the way for Congress to nullify the Constitutional right of trial by jury by mere statutory enactments." 90 F. Supp. at 986.

In *Fleitmann v. Welsbach Street Lighting Co.*, 240 U.S. 27, 36 S. Ct. 233 (1916), the United States Supreme Court reached the same conclusion with respect to the Sherman Act: "when a penalty of triple damages is sought to be inflicted, the statute should not be read as attempting to authorize liability to be enforced otherwise then through the verdict of a jury in a court of common law." 240 U.S. at 29, 36 S. Ct. at 234.

Moreover, the fact that the action is brought by the Government does not deprive the defendants of their Seventh Amendment rights. It is well settled that "the right to jury trial exists in actions by the United States where it would in a similar action between private parties." *Damsky v. Zavatt, supra*, 289 F.2d at 51 (citations omitted).

As with the statutes identified above, the Insider Trading Sanctions Act would create a civil action to recover civil penalties. *See* Memorandum of the Securities Exchange Commission in Support of the Insider Trading Sanctions Act of 1982, at 9-10, for a discussion of the civil penalty contained in the Act. Accordingly, as with the above statutes, defendants under the Act should have a constitutionally protected right of trial by jury.

Nevertheless, Congress should make the jury trial right explicit to prevent any ambiguity under the new law. As a matter of policy, there is nothing peculiar to this law to justify an exception to the practice under similar laws to permit jury trials.

Additional Sanctions

Finally, with respect to additional sanctions being sought by and proposed for the SEC, I do not believe that additional sanctions beyond cease and desist powers for egregious and emergency situations are necessary or desirable. I support the suggestion made by Arthur Mathews several years ago in an article entitled "It's Time to Give the Commission an Administrative Cease and Desist Remedy," in which he urges that the SEC be entitled to name as defendants in an administrative proceeding any registrant or issuer, or any person associated with such registrant or issuer.

The remedy would encompass the opportunity of notice, hearing, trial before an administrative law judge, and appeal to the full Commission and ultimately to the courts of appeals. The principal sanction would be an administrative cease and desist order restraining a respondent from doing any act that would cause a registrant's or issuer's SEC filings to be false, misleading, incomplete, untimely or otherwise delinquent, or an analagous mandatory administrative order compelling a respondent to take necessary affirmative acts to assure compliance with the filing requirements. The remedy would extend to all filings and reports including proxy soliciting materials. It would also extend to such nonfiling provisions as the books and records and internal controls provisions of Section 102 of the Foreign Corrupt Practices Act of 1977, newly added Section 13(b)(2) of the 1934 Act. Thus, it would be broader than present Section 15(c)(4) proceedings both in range of respondents — individuals would be included — and in conduct and filings covered.

I do not support fines and penalties for officers and directors, broker-dealers, or other persons subject to the securities laws. The remedy of an injunction, once thought to be a "mild prophylactic," is now acknowledged by the Supreme Court and other courts to have harsh and grave consequences, both legal and stigmatic.

Furthermore, I think much more effective use of existing remedies, such as criminal contempt proceedings and criminal references for prosecution, can be achieved through the use of deputized SEC attorneys as Assistant U.S. Attorneys, and through more careful surveillance of repeat violators of the securities laws. Several years ago, there were some noteworthy examples of corporations and some individuals who reportedly had repeat injunctions for additional securities violations. I think a well-publicized crackdown on such violators by invoking criminal contempt sanctions, as the SEC recently did, would impress upon people the need to respect the securities laws.

Senator D'AMATO. Mr. Jacobs.

STATEMENT OF ARNOLD S. JACOBS, ESQ., MEMBER OF THE NEW YORK BAR

Mr. JACOBS. Senator D'Amato, thank you for the opportunity to appear before your committee and, like Mr. Brodsky, I am appearing personally and am not going to try to speak on behalf of the committee on securities regulation of the New York City Bar Association, of which I am chairman. I'm here to bore you only with my own views.

I endorse the draft of the proposed Senate bill and H.R. 559.

Senator D'AMATO. Thank you very much for you incisive review of the legislation and I appreciate the time that you have given to this important area.

[The complete statement follows:]

STATEMENT OF ARNOLD S. JACOBS, MEMBER OF THE NEW YORK BAR BEFORE THE SECURITIES SUBCOMMITTEE OF THE SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE

Senator D'Amato, thank you for the opportunity to appear before your Committee. I am addressing you in my individual capacity and not on behalf of any committee or association of which I am a member, my law firm, or any of my firm's clients.

I endorse H.R. 559 and the draft of the proposed Senate bill which would add § 16(f) to the 1934 Act, subject to three comments. First, "insider trading" should not be defined in the Insider Trading Sanctions Act. Second, the wording in H.R. 559 and § 16(f)(a) dealing with trading while "in possession of" inside information is an erroneous statement of law. And third, the class of defendants under the Sanctions Act should be limited to tippers and tippees.

With respect to the first point, I am firmly opposed to inserting a definition of insider trading into the Sanctions Act for the following five reasons:

a) The law regarding the usual kind of insider trading practises is clear. Securities lawyers and those who regularly trade securities understand fully their responsibilities under the law with respect to the typical type of transaction. Hundreds of cases clarify Rule 10b-5's insider trading prohibition. As with any broad anti-fraud remedy, the fringes of what constitutes the prohibited act are occasionally fuzzy. This, however, does not justify placing a

definition in the bill; unscrupulous traders would skirt around any definition constructed. As Mr. Justice Goldberg said in the Capital Gains case:

> "'Fraud is infinite, and were a Court of Equity once to lay down rules, how far they would go, and no farther, in extending their relief against it, or to define strictly the species or evidence of it, the jurisdiction would be cramped, and perpetually eluded by new schemes which the fertility of man's invention would contrive.'"
>
> SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 193 n.41 (1963) (construing Investment Advisers Act), quoting letter of Lord Hardwicke to Lord Kames, dated June 30, 1759.

The scope of insider trading should be determined on a case-by-case basis, just as it and other fraud remedies have been construed since the beginning of Anglo-American jurisprudence.

b) Even if the Sanctions Act were redrafted to include a caveat that any definition of insider trading contained in the Sanctions Act is not to be applied to private rights of action or actions by the SEC for injunctions, it is highly probable that any definition in the Sanctions Act (although limited by its terms to the triple-profit sanctions) would become the definition for all purposes of the federal securities laws. Accordingly, if the Sanctions Act definition of insider trading were relatively narrow (as some have proposed), the overall result would be a narrowing of the insider trading prohibition in all types of Rule 10b-5 cases (including private rights of action and SEC enforcement actions). Vital as the Sanctions Act is, its importance pales when compared to the significance of private

lawsuits and SEC injunction suits. One could hardly imagine a clearer case of the tail wagging the dog.

c) I have been privileged to write eight books consisting of 4,000 printed pages on Rule 10b-5, as well as numerous law review articles containing over 750 printed pages on that subject. Those endeavors convince me that defining insider trading to cover all the panoply of potential abuses would be a very difficult and time consuming process. Many lawyers would disagree with whatever definition was formulated.

d) The argument that a definition of insider trading is needed in the Sanctions Act because it contains a penalty does not have a great deal of validity. Persons whose insider trading violated 10b-5 have been subject to criminal sanctions for over forty years. Surely a jail sentence and a fine are a greater penalty than the damages provided for in the Sanctions Act.

e) Of course, insider trading is only one of the many types of fraud 10b-5 outlaws. For instance, 10b-5 bans misrepresentations and omissions in face-to-face trades, false corporate publicity or public statements (including "cooked books"), mismanagement involving securities transactions, manipulation of the securities markets, and certain objectionable activities of broker-dealers. No one has ever seriously suggested that a definition of these prohibited practises be placed in Rule 10b-5.

The draft of § 16(f) amply demonstrates these ncerns. The draft contains wording about material non-blic information "of such a character which may reasonably expected immediately upon disclosure substantially to

affect the price of securities of the issuer." This definition of materiality has been completely abandoned since the Supreme Court defined materiality in its 1975 TSC opinion. Next, proposed § 16(f) talks about an insider employing "the information in violation of the fiduciary or contractual obligations." This represents a substantial narrowing of existing case law. Existing case law permits suits against insiders if they breach their fiduciary duty, if the person with whom they are trading has trust and confidence in them, or if they misappropriate the inside information. Similarly, the supposed definition of "tipping" - "if to his knowledge the information is imparted to him in violation of the fiduciary or contractual obligation of the person imparting such information to him" - represents a significant cutback in the definition of tipping. The Supreme Court in its 1983 Dirks case indicated that tippees could be liable if the tippee knew or should have known that the tipper conveyed the information in breach of a duty, gave the information away as a gift, or expected some personal, financial, or reputational benefit from conveying the information. It would be unfortunate to narrow the definition of insider trading in these ways.

Section 16(f)(d) is quite extraordinary. It provides that treble damages can be imposed if the use of the information was unfair whether or not there was intent to

deceive, manipulate, or defraud investors. This proposition has <u>never</u> been adopted by <u>any</u> court in <u>any</u> 10b-5 tipping or trading case.

As to my second point, H.R. 559 and § 16(f)(a) prohibit trading while someone is "in possession of" material inside information. This is an incorrect statement of the existing law. Rather, a person is prohibited from trading only "on the basis" of inside information. Courts have consistently adhered to this position, and the SEC has adopted this standard in its disciplinary proceedings.

Lastly, the Sanctions Act imposes liability on too broad a class of defendants. The draft of the Sanctions Act makes its terms applicable to aiders and abettors. The law of aiding and abetting is unclear. While there seems to be a common thread among the courts as to the elements of aiding and abetting, the definitions in the Circuits do vary. Further, the way in which the definitions are applied fluctuates widely. It would be ample to impose treble damage sanctions only on tippers and tippees.

The SEC does not need treble damage sanctions against brokerage firms to stamp out insider trading by them. The amount of money usually involved would not deter any brokerage firm from engaging consciously in insider trading. Far more of a deterrent is the Commission's ability to bar,

suspend, limit the actions of, and censure brokerage firms for violating insider trading prohibitions.

Should Congress delete the concept of aiding and abetting, the Committee Report should make clear that aiding and abetting is still available in other securities acts cases. It would be unfortunate to lose the concept of aiding and abetting through some misinterpretation of legislative history, particularly since the Supreme Court has left open the question of the existence of aiding and abetting.

I heartily endorse the policy behind Insider Trading Sanctions Act. However, there should be no definition of insider trading, any reference should be to trading "on the basis" of inside information rather than "while in possession" of inside information, and liability should be limited to tippers and tippees. These changes will avoid serious mischief which could flow from their inclusion in an otherwise laudable and socially necessary piece of legislation.

STATEMENT OF THE

COMMITTEE ON SECURITIES REGULATION

OF THE

NEW YORK STATE BAR ASSOCIATION

BANKING, CORPORATION AND BUSINESS LAW SECTION

ON THE

INSIDER TRADING SANCTIONS ACT

PRESENTED TO THE

SUBCOMMITTEE ON SECURITIES

OF THE

BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE

OF THE

UNITED STATES SENATE

APRIL 3, 1984

The Committee on Securities Regulation of the New York State Bar Association Banking, Corporation and Business Law Section is comprised of members of the New York Bar a principal part of whose practice is in the field of securities regulation. Among other things, the Committee follows proposed changes in Federal and state laws and regulations affecting securities. The views in this statement are the views of the members of the Committee and do not necessarily reflect the views of the firms with which they are associated, the New York State Bar Association or its Banking, Corporation and Business Law Section.

On May 20, 1983 the Committee submitted a letter commenting on the Insider Trading Sanctions Act to this Subcommittee and the Subcommittee on Telecommunications, Consumer Protection and Finance of the House of Representatives Energy and Commerce Committee. Although much of our prior letter remains relevant, because of the changes that have now been made in the bill, we have new concerns which we are addressing in this statement.

The Committee on Securities Regulation supports the objectives of the Insider Trading Sanctions Act and its general approach. The Committee agrees that insider trading violations undermine the integrity of our securities markets and that existing sanctions appear to be inadequate to prevent serious violations from occurring. However, the Committee also believes that certain aspects of the present bill create unnecessary complications for the securities industry and

that these problems can be solved without in any way interfering with the accomplishment of the objectives.

Proposed Definition

Yesterday the Committee received for the first time a copy of a new section proposed to be inserted in the Securities Exchange Act of 1934 as Section 16(f) which would purport to define more clearly the conduct which would be subject to the sanctions envisaged by this legislation. The Committee on Securities Regulation opposes the insertion of such a definition in the context of this legislation. The original idea behind this bill was that new sanctions were needed to deter clearly recognized violations, not that there should be a new delineation of the parameters of what constitutes a violation of Rule 10b-5. In any event, we do not feel that legislation increasing sanctions is the appropriate context for a reconsideration by the Congress of the concept of insider trading violations.

Insider trading violations of the type now being prosecuted by the SEC and, in some cases, U. S. attorneys, have developed from events that were not precisely foreseen at the time most of the Federal securities laws were enacted. Most actions today are brought under Rule 10b-5, a rule adopted by the SEC in 1942 under the rather vague mandate of Section 10(b) of the 1934 Act which makes it unlawful to employ "any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the

Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors". The language of the Rule is equally obscure and almost never figures in judicial determinations of whether the Rule has been violated. It is incredible to believe that the draftsmen of the 1934 Act could have conceived of the development of insider trading actions -- both by the SEC and in civil actions for damages -- which has occurred under Section 10(b) and Rule 10b-5.

Perhaps the time has come when a reassessment by the Congress of civil actions under Section 10(b) and Rule 10b-5 should be undertaken. Many aspects of these actions would best be served by Congressional clarification and codification, such as the statute of limitations, the concept of "scienter", the limitation on suits to persons who are actual purchasers or sellers, the "personal benefit" requirement recently articulated for the first time and the availability of actions under the Rule in cases where the statute contains different express remedies. However, this is neither the right time nor the proper context to undertake such a reconsideration. No comprehensive analysis of the cases has been prepared, studied or debated, many of the aspects of the cases are controversial and the courts and the SEC are continuing to pursue individual problems on a case by case basis. Moreover, the purpose of this legislation was never to codify the existing law of insider trading or to provide guidance for future developments by the Courts, but rather

to increase deterrence by providing stiffer penalties. It could, indeed, be counterproductive if a new, hastily prepared definition of conduct which would constitute a violation were widely interpreted as approving conduct not covered -- i.e., providing a "roadmap for fraud".

The Committee on Securities Regulation has not had sufficient time to study the proposed new Section 16(f), but the Committee would not favor the approach taken by this new Section. Although present law on what constitutes an insider trading violation may not be entirely clear, the Committee on Securities Regulation thinks it is clear enough to justify the imposition of treble damage sanctions where a violation is demonstrated by "clear and convincing evidence". For the same reason, the Committee feels that the bill should address only those sections of the 1934 Act, namely Sections 10(b) and 14(e), that deal expressly with insider trading, as opposed to "any provision of this title or the rules and regulations thereunder." In effect, this would allow the Courts to continue to develop the law in this area as they have been doing in the past and the time for a Congressional reassessment would wait until a better foundation had been laid.

Phraseology of Standard of Violation

One area that continues to be a major concern for the Committee on Securities Regulation is the potential application of the new Act to large securities firms that

routinely purchase and sell securities for their own accounts -- e.g., in arbitrage, block positioning, market making and principal transactions generally. Many of these firms indisputably have legitimate access to inside information, particularly from investment banking and research activities. Unfortunately, the phraseology of the bill -- which refers to violation in term of a purchase or sale "while in possession" of material nonpublic information rather than "on the basis" of such information -- may result in uncertainty as to whether these firms are routinely violating the law. While the Commission will probably not bring irresponsible actions against such firms, this language could result in a de facto shift in the burden of proof, in private actions as well as SEC enforcement proceedings.

The House report (H.R. Rep. No. 98-355, 9/15/83) endorses the concept of a "Chinese wall" to protect firms which trade "while in possession" of inside information. However, nothing in the bill itself actually delineates this concept. Indeed, the "Chinese wall" idea is barely articulated, if at all, in existing case law.

The bill does contain a sentence, inserted by the House, to the effect that no person will be liable solely by reason of employing another person who is liable. However, the liability that is of concern here is not liability that arises "by reason of employing" another person but rather the liability of the firm itself, because it purchased or sold "while in possession" of material nonpublic information.

Indeed, there are many SEC enforcement proceedings which allege that action by a single individual within a firm was action "by the firm" for purposes of different provisions of the Federal securities laws. Thus, it would appear a simple matter for the SEC to make out a *prima facie* case under the "while in possession" standard, and at that point the burden of proof would shift to the firm to show why it did not violate the law.

However, this is completely unnecessary, for the problem stems only from the "while in possession" language rather than the correct concept of a purchase or sale "on the basis" of material nonpublic information. The House report itself confirms that liability would arise for those who trade "on the inside information" (pp. 10-11), which sounds pretty much like "basis". The letter submitted by the Committee on Securities Regulation on May 20, 1983 to this Subcommittee and the Subcommittee on Telecommunications, Consumer Protection and Finance of the House of Representatives Energy and Commerce Committee included suggested draft language which would have phrased the violation in this manner, and we suggest that it be used instead of the "while in possession" concept.

Standard of Proof

The Committee on Securities Regulation has consistently taken the position that this bill should require "clear and convincing evidence" in order to establish a

violation for which treble damages may be imposed. In this regard, it must be recognized that the purpose of this bill is punitive, not remedial. In most cases the "civil" penalty that would be imposed under this bill would far exceed the $100,000 "criminal" fine, which would require proof "beyond a reasonable doubt".

The SEC has steadfastly opposed the clear and convincing evidence standard, arguing that a higher standard would reduce the number of successful actions brought by the SEC. But so what? By the same token, reducing the Consitutional protections afforded to defendants in criminal cases would undoubtedly increase the number of successful prosecutions; but both situations would result in a departure from established standards of fairness and equity.

Much of the debate that has been going on about this issue has attempted to demonstrate that a "preponderance of the evidence" test, as urged by the SEC, would be approved by the Courts. Although the Committee on Securities Regulation is not convinced that this has been, or could be, demonstrated, the debate is nevertheless not focusing on the right question. That question is whether it is fair to impose the quasi-criminal, or at least extraordinary, sanctions envisaged by this bill upon a person in the absence of "clear and convincing evidence". Given the de facto shift in the burden of proof which we think would result from the loose phraseology of the standard of violation, it is all the more necessary for a violation to be

demonstrated very clearly. Moreover, there has been no demonstration that the "clear and convincing evidence" test would not be satisfactory in the major actions that have been brought by the SEC. Finally, if the SEC could satisfy the "preponderance of the evidence" test but not the "clear and convincing evidence" test, it would still be able to obtain an injunction against further violations and require the defendant to disgorge his actual profits realized -- not insignificant sanctions.

Aiders and Abettors

The Committee on Securities Regulation questions the fairness of imposing liability upon persons who do not receive the profits from the purchase or sale of securities. The House Committee Report took the position that aiders and abettors in some circumstances should be liable as "direct violators". Although we recognize that the bill has been somewhat narrowed by limiting aiders and abettors to those who communicate material nonpublic information, there is still overkill here. It should be sufficient for single damages to be imposed upon someone who merely communicates information that another chooses to utilize unlawfully.

Other Comments

The Committee also has the following other comments on this bill:

(1) The Committee believes that it is not necessary or desirable for the bill to be limited to transactions on or through the facilities of a national securities exchange or from or through a broker or dealer which are not a part of a public offering by an issuer of securities other than standardized options. This mysterious limitation appears to be based upon some compromises by the SEC or its staff which have never been fully explained. We think language like this weakens the bill.

(2) The Committee sees no reason for the bill to authorize the Attorney General to bring a separate action to recover the penalty where a person does not pay a judgment imposed by Court order in an action brought by the SEC. Violation of a court order ought to be subject to the usual contempt sanctions.

(3) The logic inherent in the 1934 Act would suggest that the penalty imposed by this legislation be placed in Section 32, a section dealing expressly with penalties, and that the authority of the SEC to bring the action be placed in Section 21.

(4) The Committee would like to have additional time to study and comment on the language of proposed Section 16(f) which it just received for the first time yesterday.

The Committee on Securities Regulation thanks the members of the Subcommittee on Securities for giving us this opportunity to present our views to you today on the Insider Trading Sanctions Act.

Respectfully submitted,

Richard R. Howe
Chairman
Committee on Securities Regulation

Senator D'AMATO. Faith Colish.

STATEMENT OF FAITH COLISH, ESQ., CHAIRMAN OF THE COMMITTEE ON SECURITIES AND EXCHANGES, NEW YORK COUNTY LAWYERS ASSOCIATION.

Ms. COLISH. Mr. Chairman, it's an honor to have an opportunity to speak to you on a draft of the bill. As my colleagues on the panel have said, I state for the record that I am chairman of the committee on securities and exchanges of New York County Lawyers Association, but at this time I am not speaking in that capacity but as a practicing attorney.

I guess I don't have to tell the Senator that whenever an important issue comes up, you are faced with balancing of conflicting values and there is no single public policy to be advanced. Here the balancing act is between the need to maintain investor confidence, the integrity of the securities markets and on the other hand the need to have the functioning of securities analysts and other professionals who seek out and bring to the market the information which makes it vital and efficient.

To me, the polestar in balancing these two sometimes apparently conflicting consideration is what would foster the reasonable expectations of the investing public and for this purpose I think we have to take a look at what is the meaning of material and what is the meaning of nonpublic.

HOMESPUN DEFINITION OF NONPUBLIC INFORMATION

In my mind, the kind of nonpublic information that should be dealt with by this type of bill is not that necessarily which is not generally known but that which we are not supposed to know. That may sound like a little homespun definition, but it is a fact that securities professionals and sometimes nonprofessionals encounter information which anybody could find if they took the trouble and had the diligence to seek it out.

There is a classic example, which is cited by a former chief of enforcement of the SEC, of a motorist driving along a deserted road who observed a huge explosion in the XYZ plant. He owns XYZ stock and he picks up the telephone and calls his broker and says, "Sell XYZ". I personally don't think that that's the kind of activity that should be prohibited.

You, as representatives of the people of the United States, will determine what represents the collective view of the public and what kinds of things are offensive and aren't, but the point I'm trying to make is that the mere fact that not everybody knows about it should not prohibit its use.

In a more professional context, a securities analyst may be the first one to find out that a court decision has been rendered which will have an impact on the value of stock or he may be the first one to call up management and say, "What is your position on such and such a question," and get an answer. I don't think that in itself makes it inside information provided the information is available to anybody who wants it.

In the examples I've given, I assume that neither the giver nor the receiver of the information is breaching a recognized contrac-

tual or fiduciary duty with respect to that information and I commend your draft for focusing on that concept because I think it really goes a long way in helping to sort out what kinds of conduct are reprehensible and what kinds are useful and should not be prohibited.

Two other points that I'd like to make about what I think the public reasonably expects and is reasonably entitled to.

First of all, the term "material" has a well developed meaning in securities law. In certain contexts some kinds of information is material which may not be material to a particular transaction. I believe Mr. Freeman in his observations has made that point and I think that in determining whether the information is material for purposes of this kind of a penalty provision what you must look at is whether it was material in the context of the trading transaction.

Second, I think that it is important to distinguish between possession and use of the information. I understand that the administrative and judicial gloss on the term "possession" treats it as if it says "on the basis of trading", or "using" inside information. To me the simple thing would be to say just what you mean but if in fact for whatever reason, you are going to use the word "possession", in this context, I think it should be clearly understood that it is limited by the interpretations that have been given to it historically.

On that point, I'd like to mention that frequently possession of information is probative of the fact that it was used. However, it isn't necessarily conclusive proof that it was used. I have in mind the example of the marketmaker who day after day trades thousands and thousands of shares of stock as a wholesaler, as a financial intermediary. If that marketmaker were to come upon some truly inside information, should he necessarily be inhibited from continuing to make a market? I don't think so. I don't think his trading is "on the basis" of his inside information.

In summary, I think that the bill represents a giant step toward resolving the problems of insider trading and in particular goes almost all the way we need to go in terms of the definition.

On the subject of the definition, I'd like to just comment that I think we all recognize that this penalty provision is intended to be supplement to, and not a substitute for rule 10b-5 and whatever definition is used in this context would not need to and should not impair any existing rights of injured parties, or of the SEC, or of the Government to bring action for wrongs that have been committed or fraud that has been committed.

I find it very interesting that this section has been drafted as a piece of section 16 of the Securities Exchange Act which, by its nature is a somewhat arbitrary provision. The basic section 16 provision, as securities lawyers know, says if you are a 10-percent shareholder, officer, or director, you are liable for short-swing profits irrespective of whether you have any information whatsoever, if you had zero information. It's a prophylactic and arbitrary provision. That concept has not been transported over to 10b or any other part of the law. It's separate and I think the fact that this insider trading provision is in that area of the statute—otherwise the location is not going to be conclusive—but I think it represents

an attitude that it is separate and special and not in lieu of or in derogation of any other statutory provision, and I do feel that the standards that this bill sets forth are appropriate in the context of the penalty. The fact that the penalty might fall on a narrower class of people than would be liable under rule 10b–5 is not a problem at all to me. I think they are alternatives and the existence of one doesn't take away from the value of the other.

SPECIFIC COMMENTS ON LANGUAGE OF THE BILL

I have a few specific comments on some of the language of the bill which I think does need some work. For example, in paragraph (B) there's reference to an "offering person" which I take to mean reference to a person who is or is contemplating making a tender offer. I'm not sure why that category of person or the agents for that category of person or indeed sellers to that category of person should be exempted. If you're making a tender offer, then presumably you comply with the provisions of the law relating to the tender offer or exchange offer or whatever it is, and you are subject to very specific and strict disclosure requirements. So this doesn't seem to be an area that needs more regulation, at least not in this sense.

However, if you're talking about the preoffering period, that seems to me to be an area that is particularly sensitive in terms of potential abuse and actual abuse and I don't know why you want to exclude that whole area of conduct from potential penalty.

There is also discussion in paragraph (C) of the bill of provisions which are intended to recognize the absence of ipso facto respondeat superior language—if you'll excuse me for using two Latin phrases in one sentence—and also the notion of a Chinese wall separating different departments of brokerage firms. I think that although we all know what we mean when we say Chinese wall in this room at least, I'm not aware of any cases that really spell out what is effective or a proper Chinese wall and in view of the uncertainty of that, I think the language here might bear further refinement. And also, if you accept the concept that possession is not the test but use of the information is the test, that would go a long way to reducing the problem which arises in a multiservice firm situation.

Paragraph (D) of the bill makes it clear that fraudulent purpose is not the test and I think that's a proper approach to take along the lines of somewhat arbitrary nature of section 16. I think that the elements that have been set forth in the bill as the basis for this type of penalty, namely nonpublic, material information used in breach of a contractual or fiduciary duty, are sufficient criteria for what should be penalized under this kind of legislation.

I'm a little troubled by the additional use of the term "unfair." Now I'm against what's unfair just as much as you are, but I don't think that it's a good statutory language. I think that you're almost a gilding the lily here and I think you would be better off with just saying what you mean and not leaving that somewhat vague term appended.

Finally, in line with what Mr. Brodsky said, I happen to understand that the bill is specifically designed only to enable the Gov-

ernment to bring action for penalty for up to three times the wrongful profit and it's not intended to create a private rights of action. I think it's very important in light of the way the courts have dealt with this question to say so, if not in the bill, at least very clearly in the legislative history.

Thank you very much for the opportunity to speak here.

Senator D'AMATO. Thank you for your very fine analysis and obviously the work that you've put into reviewing this proposal, Ms. Colish.

[The complete statement follows:]

STATEMENT OF FAITH COLISH, ESQ.
BEFORE SECURITIES SUBCOMMITTEE OF THE SENATE BANKING COMMITTEE ON SENATOR D'AMATO'S DRAFT BILL ON TRADING ON NON-PUBLIC INFORMATION

April 3, 1984

Mr. Chairman and Members of the Committee:

It is an honor to have the opportunity to speak to you on a draft of a bill, prepared by Senator D'Amato, to control the use of material non-public information in securities transactions. I am the Chairman of the Committee on Securities and Exchanges of the New York County Lawyers Association, and am a member of various other bar associations. I appear before you today, however, not as a representative of those organizations but as a lawyer who has specialized in securities regulatory matters - both on the SEC staff and as a member of the private bar - for over 20 years.

In addressing the question of "insider trading", as is typically the case, one seeks to balance two goals: the need to maintain investor confidence in the integrity of the securities markets, and the legitimate functioning of securities analysts and others who seek out and bring to the market the information that makes the marketplace uniquely vital. In weighing what may appear to be conflicting considerations, the pole star should be the reasonable expectations of participants in the market. This takes us directly to the questions of what is "material," "non-public" information.

First, it should be clear that the "non-public" information, use of which is addressed in this bill, means that which the public is not <u>supposed</u> to know, rather than information which is knowable but not yet widely known. A frequently-cited example is the case of the motorist on a deserted road who sees a huge explosion at a plant of XYZ Industries, whose stock he owns. The motorist picks up the telephone in his car and orders his broker to sell his XYZ stock. Under these facts, I don't think the average investor would expect the motorist to refrain from selling, and therefore I don't think that a penalty on such activity is necessary to maintain investor confidence.

The same reasoning applies to the situation where a security analyst happens to be the first person to learn that a decision has been filed in court affecting the outlook for a particular stock, or the analyst happens to be the first person to discuss with a company's management a question which it is management's policy to discuss with any analyst.

For example, in tender offers, the bidder and the target company frequently retain representatives to field questions from brokers and others. Information which such representatives are authorized and instructed to discuss with callers should not be treated as "non-public".

In these examples it is assumed that neither the giver nor the receiver of the information is breaking a recognized contractual or fiduciary duty with respect to the information. This bill recognizes that distinction and, in so doing, makes an extremely valuable contribution to management of the problem of "non-public" information.

Two other points should be mentioned in terms of the reasonable expectations of the investing public. First, the materiality of the information, use of which may give rise to a penalty, should be evaluated in the context of the challenged transaction. In other words, the fact that a statement or omission may be material in the context of what must be set forth in a disclosure document filed with the SEC does not necessarily mean that it is material in the context of the trading market.

Also, this bill addresses activities a person engages in while in "possession" of certain kinds of information. There are situations where mere possession would not be sufficient to give rise to a reasonable expectation that the possessor would have to abstain from trading. For example, broker-dealers acting as market makers regularly buy and sell on a wholesale basis and may effect transactions day after day without regard to any specific piece of information about the issuer. If such a broker-dealer were to become privy to truly inside information (of the kind which is not supposed to be known) should he have to stop his market-making activities? I think not, and I think that the distinction lies in the difference between possession of information and action on the basis of such information.

In many cases, possession of information may raise a presumption that the possessor used it and traded on the basis of it. However, this presumption should be rebuttable upon a proper evidentiary showing. I am informed that in commenting on similar language in the House bill, H.R. 559, the SEC stated that they interpret the phrase "while in possession of" to mean "on the basis of". If this bill is intended to deal only with the "use" of inside information, it would obviously be better to refer to "use", not "possession". If, for whatever reason, the present wording of this bill is retained, Congress should make it clear that the word "possession" is used in light of its administrative and judicial gloss.

I think that this bill represents a giant step forward in the effort to deal with the problems of "insider trading". I have a few specific comments on the language of the current draft.

1. Paragraph (b) of the bill excludes transactions on behalf of an "offering person", which I understand is intended to mean a person who is contemplating, or is currently making, a tender offer or similar offer to acquire securities of the issuer. If this is indeed the intended meaning of "offering person", a clearer description could be given. Moreover, the need for this exemption is not clear. If a tender offer is currently in progress, all purchases by the offering person must be made pursuant to the terms of the offer, which is subject to strict disclosure obligations. If the transaction is in the pre-offering period, I know of no basis for exemption from regulation. Indeed, the pre-offering period is conspicuously sensitive in terms of potential insider trading abuses.

2. Paragraph (c) of the bill includes a recognition that an employer should not, ipso facto, be held responsible for the wrongdoing of his employee, and recognizes the concept of the "Chinese Wall" under which the activities of the research or investment banking division of a multi-service firm may be insulated from its trading department, so that the firm's traders are not charged with knowledge that they do not actually have. Although the idea of a "Chinese Wall" has been widely discussed and is generally understood in principle, there do not appear to be many cases in which this concept has been tested in litigation, so that the industry may not have clear guidelines as to what constitutes adequate separation of departments. In light of this uncertainty, the wording of this part of the bill could be clearer. Also, if the bill were expressly to cover only transactions effected "on the basis" of non-public information, certain problems with respect to insulation of departments would be obviated.

3. Paragraph (d) of the bill states that no showing of fraudulent purpose is necessary to establish a violation giving rise to a penalty. Since the bill does require a showing of breach of an independent fiduciary or contractual duty, I agree that it should not be necessary to inquire into the defendant's subjective intent. However, Paragraph (d) goes on to imply that it must be shown that the use of information was "unfair". This would reintroduce an even more undesirable, vague subjective test. It should be clear that this bill does not mandate "fairness" in the sense of equality of information. The existence of a breach of duty, together with the requirements that the informtion be non-public, material, and the basis on which the defendant made his investment decision, are sufficient armor against assaults on public confidence in the fairness of the securities markets.

Finally, I understand that this bill is intended solely to give the government the right to collect a penalty of up to three times the amount of wrongful gain (or loss wrongfully avoided), and that it is not intended to create a cause of action for treble damages on the part of the injured party, who would, of course, continue to have all the rights and remedies the law now affords. I endorse this approach and urge the Committee to make manifest its intent not to create private rights of action under this bill.

Thank you very much.

Senator D'AMATO. Mr. Miller, you're the last of our panelists and by no means the least.

STATEMENT OF SAM SCOTT MILLER, ESQ., GENERAL COUNSEL, PAINE WEBBER, INC.; ON BEHALF OF THE SECURITIES INDUSTRY ASSOCIATION

Mr. MILLER. Thank you, Mr. Chairman. I'm Sam Miller and I'm general counsel for Paine Webber, Inc., a financial services holding Company. Unlike my colleagues, I am appearing today before you in a representative capacity, on behalf of the Securities Industry Association.

[The complete statement follows:]

THE INSIDER TRADING SANCTIONS ACT

Statement

of the

SECURITIES INDUSTRY ASSOCIATION

Presented by

SAM SCOTT MILLER

VICE PRESIDENT and GENERAL COUNSEL

PAINE WEBBER INCORPORATED

Before the

SUBCOMMITTEE ON SECURITIES

of the

SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

April 3, 1984

Mr. Chairman, Members of the Subcommittee:

I am Sam Scott Miller, Vice President and General Counsel of Paine Webber Incorporated, a financial services holding company. I am appearing before you today on behalf of the Securities Industry Association.

The Securities Industry Association is the trade association representing over 500 securities firms headquartered throughout the United States and Canada. Its members include investment banks, brokers, dealers and mutual fund companies as well as specialists and other firms functioning on the floors of exchanges. SIA members are active in all exchange markets, in the over-the-counter market and in all phases of corporate and public finance. Collectively, they provide investors with a full spectrum of securities and investment services and account for approximately 90% of the securities business in North America.

We appreciate the opportunity to appear before the Subcommittee in its consideration of amendments to the Securities Exchange Act. SIA supports the objective of increasing the sanctions applicable to unlawful insider trading in the securities markets. We share the Securities and Exchange Commission's view that such trading "undermines the expectations of fairness and honesty that underlie public confidence in [the] securities markets."* At this time, we believe that legislation directed to this purpose should be precisely defined and provide predicta-

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* Memorandum of the Securities and Exchange Commission in support of the Insider Trading Sanctions Act of 1982 (September 27, 1982).

bility. It should not introduce new confusion into an already complex body of law. In particular, the legislation should

- Apply punitive sanctions only against wrongdoers who act knowingly on the basis of inside information; and
- Avoid any attempt to expand the law of insider trading further into the imbroglio of market information.

<u>The Present Bill</u>

The Insider Trading Sanctions Act has been described as a measure that would increase the penalties of insider trading without changing the underlying law.* Contrary to its packaging, the bill passed by the House (H.R. 559) could be read to make significant changes in that law. For instance, the penalty might be assessed against persons not directly participating in or aware of the violation or against persons in possession of inside information even though that information was not used as a basis for trading. Moreover, despite protestations by its draftsmen about the pitfalls of providing a definition of insider trading, the bill itself changes the law of insider trading that has been fashioned by the courts.

<u>Possession vs. Basis</u>

The most unfortunate change in existing law attempted by H.R. 559 is imposition of the treble damage remedy against persons who trade "while in possession of material nonpublic

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* <u>See</u> H.R. Rept. No. 355, 98th Cong., 1st Sess. (hereinafter called the "House Report"), at 13.

information." The legislation should instead be couched in terms of trading "on the basis of" covered information.*

If persons making investment decisions do not make those decisions based on covered information, they should not be liable for the penalty. For example, individuals in one department of a multi-service financial firm or bank may have possession of material inside information while persons in another department making the relevant investment decision are not aware of the information. Although the firm is "in possession" of material nonpublic corporate information, the trades are not made "on the basis of" the prohibited information and therefore are not unlawful under existing law.

The basis standard was enunciated by the Securities and Exchange Commission in Investors Management Co.,** where proceedings were dismissed against an advisor to an investment

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* Chairman Shad implicitly acknowledged this point in his testimony before the House Subcommittee on Telecommunications, Consumer Protection, and Finance of the House Committee on Energy and Commerce ("House Testimony") when he stated:

> Trading on the basis of material nonpublic information -- a practice which impairs confidence in the integrity of the securities markets -- has been the subject of a number of recent cases.... The [Dirks] decision strongly reaffirmed that both insider and tippee trading on the basis of nonpublic, material information is prohibited under the federal securities laws.... The government, in [the Newman case]...emphasized the broad, remedial nature of the antifraud provisions, the nexus between the fraud and the defendant's purchase and sale of securities...." House Testimony at 36-38. (Emphasis supplied.)

** 44 SEC 633 (1971).

fund even though his firm possessed material inside information, because the advisor was able to demonstrate that the trades in question were not based on that information. The Commission stated that an essential element of any tippee violation of rule 10b-5 is that the information be "a factor in the investment decision." It found no violation in this case because it concluded that the employee who had been tipped to material adverse information did not disclose that information to his superior, who made the investment decision based on other considerations.

Burden of Proving Non-Access

The House Committee on Energy and Commerce has recommended that the SEC adopt under the legislation a rule similar to rule 14e-3.* That rule provides that a person other than a natural person must do two things to escape liability if it has traded while in possession of material nonpublic information: (1) prove that the individual making the investment decision was not aware of the material nonpublic information; and (2) demonstrate that it had adequate procedures to ensure that the investment decision-maker did non possess material nonpublic information.** The double requirement of no-awareness and adequate procedures is unique, however, and does not apply otherwise to the law of

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* House Report at 11; see also letter of SEC Chairman John S.R. Shad to the Honorable Timothy E. Wirth, Chairman, Subcommittee on Telecommunications, Consumer Protection and Finance (June 29, 1983) [hereinafter cited as the June 29 letter], reprinted in House Report at 27.

** Whether this rule has been validly adopted under section 14(e) is beyond the purview of this statement.

insider trading, as the Commission implicitly acknowledges in a footnote to its June 29 letter.*

Under H.R. 559, a securities firm unable to demonstrate effective Chinese Wall procedures could be subjected to treble damages even though no one acted fraudulently or with intent to deceive. This result is clearly at odds with the stated purpose of the legislation as well as the requirement under existing law of intentional or willful conduct designed to deceive or defraud investors for a finding of a violation of section 10(b).** The penalty provided by the proposed legislation should be applied only to those who knowingly profit on the basis of inside information. After all, it is this group against whom deterrence is intended.

There is simply no need for a more onerous standard. In Investors Management, the Commission said that it would "view as suspect and subject to close scrutiny a defense that there was no internal communication of material, nonpublic information and its source by a member of a broker-dealer firm or other investment organization who received it, where a transaction of the kind indicated by it was effected...thereafter." This passage emphasis that a securities firm would indeed have a heavy burden of proving that trades were not made on the basis of information possessed somewhere in the firm. Effective internal procedures should be helpful in establishing this defense, but would not be

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* House Report at 28 n.52; accord, House Report at 11.

** See Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

required if the defendant could otherwise demonstrate that the information was not used in the investment decision.*

No-Fault Liability

H.R. 559 could be construed to change existing law by expanding the class of persons potentially liable to reach those not directly participating in the violation. In describing the effect of the proposed bill, the Commission states that "aiders and abettors (other than tippers) of those who violate would not be subject vicariously to the new penalty";** however, the language implementing this principle in the statute is susceptible to a considerably broader reading.***

To illustrate, proposed subparagraph (d)(2)(A) to section 21(d) of the Securities Exchange Act would expressly apply the increased penalty to aiders and abettors. Unfortunately, the limiting language of the first sentence of subparagraph (d)(2)(B), i.e., that "[n]o person shall be subject to a sanction...solely

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* See Miller, Chinese Walls, 8 Rev. Secs. Reg. 865, 866 (1975).

Judicial interpretations of section 10(b) make it clear that with respect to "insider" trading, it is aimed at policing insider conduct and, under some circumstances, their tippees. See Dirks v. SEC, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶99,255, at p. 96,125 n.14. Unless the firm acts on the basis of the information in question, the person (i.e., the investment banker to whom information was communicated) would not have breached the company's confidence which communicated the information to the banker. While it may be a "constructive insider" under Dirks, it would not have engaged in any unlawful conduct.

** House Report at 27.

*** Moreover, discussion of "existing law" provided by the House Report can only be characterized as misleading. See pp. 9, 10 and 17.

because that person aided and abetted a [covered] transaction... in a manner other than by communicating material nonpublic information," would not be available to a securities firm whose agent-broker did in fact communicate such information, even though that communication was unauthorized and in no way sanctioned by the firm. Neither would the firm necessarily avoid liability in these circumstances by the second sentence of subparagraph (d)(2)(B), which provides that control-person liability under section 20 does not apply to actions brought under the penalty section, because section 20 is not the exclusive avenue for reaching employers of violators (at least in a majority of the circuits). While it might be argued that the third sentence of subparagraph (d)(2)(B) bridges the latter gap, that sentence unfortunately leaves room to argue that liability should attach to the firm other than "solely by reason of employing another person who is liable,"* for instance because of allegedly inadequate procedures. By analogy, the Commission has argued that aiding and abetting liability can be established against persons who "should have been able to conclude that the act was likely to be used in furtherance of illegal conduct.** Finally, the Commission asserts that the respondeat superior doctrine is sufficient to impose civil liability on a brokerage firm under

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* This statement gives rise as well to an unwarranted inference that respondeat superior may otherwise form the basis for an insider trading violation.

** Brief for SEC in Investor Research Corporation v. SEC, 628 F.2d 168 (D.C. Cir.), cert denied 101 S. Ct. 317 (1980). The House Report erroneously suggests an even lesser standard as reflective of existing law. At 10.

section 10(b) of the Exchange Act and that the state of mind of the primary wrongdoer satisfies the scienter requirement of section 10(b).*

Thus we see that under subparagraph (d)(2)(A), the Commission might seek to hold a firm vicariously liable for treble damages, even though it had not traded on unlawful inside information. The limitations of that subparagraph are vulnerable to circumvention by a creative enforcement staff,** and subject to varying interpretations by courts.

Further, neither sections 10(b) nor 14(e) of the Exchange Act expressly provide for aiding and abetting liability, and the Supreme Court has declined to address such liability under the securities laws.*** It is inappropriate to address that issue through an amendment to the penalty section of the Exchange Act. Regardless of whether or not a person could be held liable as an aider or abettor in the context of an injunctive or civil damage action, the treble damage penalty should only be available against persons who directly cause the violation.

Moreover, the aiding and abetting standard would further cloud the state-of-mind required for the treble damage penalty,

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* SEC brief as amicus curiae at 5, Smith Barney, Harris Upham & Co., Inc. v. Hendricksen, 102 S. Ct. 669 (1981). The House Report adopts this position as reflective of existing law (at 10), despite an absence of judicial acceptance.

** See Dirks v. S.E.C., [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶99,255, at p. 96129 n.24; cf. House Report at 7 ("The Committe believes these and other existing remedies should be used aggressively and creatively....").

*** Ernst & Ernst v. Hochfelder, 425 U.S. 185, 191-92 n.7 (1976).

because it is unclear whether violators of section 14(e) of the Exchange Act must act with scienter. Although the Supreme Court held in Hochfelder and Aaron that scienter is a necessary element of an action under section 10(b), the Court has not yet addressed whether it is a requisite element of a violation of section 14(e). Nonetheless, the language of section 14(e) is parallel in all relevant respects to that language which led the Supreme Court to conclude that violators of section 10(b) must act with scienter. The Commission maintains, however, that it need only prove negligence in establishing violations of section 14(e).*

If only to avoid the myraid litigation necessary to define the vague contours of subparagraph (d)(2)(B), the avowed purpose of attaching secondary liability to tippers may be achieved effectively and simply by eliminating aiders and abettors from the purview of the bill and substituting therefor persons who "knowingly cause" violations. This would avoid inflicting punitive damages on innocent, even though possibly negligent, financial institutions and would accord totally with the Commission's statement of intent.**

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* But see SEC v. Texas International Co., 498 F. Supp. 1231, 1252 (N.D. Ill. 1980) (both sections 10(b) and 14(e) "merit the same standard of culpability").

** See the second paragraph under "Secondary Liability" of the Commission's June 29 letter. House Report at 28. This approach would also be consistent with the House Committee's understanding that the proposed legislation "does not change the underlying substantive case law of insider trading as reflected in judicial and administrative holdings." House Report at 13.

Expansion of Law of Insider Trading

The proposed legislation should not be used to expand obliquely the law of insider trading. Section 2 of H.R. 559 refers to purchasing or selling securities while in possession of material nonpublic information. It is clear, nonetheless, that not all trading by persons having possession of or based on material nonpublic information violates the antifraud provisions of the federal securities laws.* While trading on nonpublic market information may, in some circumstances, violate the securities laws because of a breach of customer or other fiduciary relationships, it does not do so -- nor should it -- in every instance.** The proposed legislation should avoid expanding the law in a manner that would act to preclude or inhibit desirable market activities.

Conclusion

As the Commission pointed out in its June 29 letter, "existing law provides a sound legal framework for judicial analysis and review of new and unforeseeable trading devices and strategies. Decades of legal thinking have contributed to the development of existing antifraud law under Rule 10b-5".*** The legislative record thus far indicates no express intent to subject to the treble damage penalty anyone other than those who trade on

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* See Dirks v. S.E.C., [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶99,255, at pp. 96,126-27 (1983); Chiarella v. U.S., 445 U.S. 222, 231-35 (1980).

** See, e.g., Dirks v. S.E.C., supra, at pp. 96,126-27.

*** House Report at 32.

inside information, as defined by the courts, and those who cause such transactions. The language of the proposed legislation should be modified to reflect that intent.

Finally, while we have concentrated on the insider trading provisions, we note that section 4 of H.R. 559 would amend the Exchange Act by adding section 14 to those provisions subject to administrative proceedings under section 15(c)(4) of the Act. This change has not been examined thus far in the hearings and is not generally understood. The assertion in the House Report that exclusion of the proxy reporting requirements of section 14 from section 15(c)(4) was a drafting oversight is not persuasive. Since the amendment could result in increased involvement by the Commission in -- and alter the balance of -- corporate-control contests, we do not believe this amendment should be implemented without full legislative consideration of its ramifications.

Subcommittee Draft of Section 16(f)
To Make Unlawful Unfair Use of Information

The second subject of today's hearings is a draft authored by this subcommittee which amends the Securities and Exchange Act by adding a new Section 16(f). The subcommittee draft would make unlawful certain "unfair use of information" in connection with

securities transactions and enable the Securities and Exchange Commission to compel the violator to pay up to three times the profits gained or losses avoided from such trading to the U.S. Treasury. Specifically, subsection (a) of the subcommittee draft makes it unlawful for any person possessing material nonpublic information to profit (or avoid loss) if such person (1) employs the information in violation of his own fiduciary or contractual obligation, or (2) employs such information which he knows has been imparted to him in violation of the fiduciary or contractual obligations of the person communicating such information to him. Subsection (a) also makes unlawful the aiding and abetting of such activity. Subsections (b) and (c) limit, to some extent, the application of subsection (a). Subsection (d) states that the Commission, in bringing an action under the section, need not establish that the violator acted with an intent to deceive or defraud but only must prove that the "use of information was unfair as violating an express or implied obligation." Only the Securities and Exchange Commission can maintain an action under the section.

The subcommittee draft is an interesting approach to securities legislation aimed at preventing securities transactions affected on the basis of material nonpublic information. We

understand that primarily two considerations provide the impetus for the subcommittee's attempt to do more than providing the Commission with additional penalties for use against persons trading on the basis of certain material nonpublic information. The first is the perceived gap in securities regulation resulting from the Court's decision in United States v. Chiarella in which a conviction against a person who "misappropriated...[or] stole...valuable nonpublic information entrusted in him in the utmost confidence"* was reversed because, among other reasons, a duty to disclose under section 10(b) does not arise from the mere possession of material, nonpublic information.** The second is the Commission's concern that it will be difficult, in light of the Dirks decision, to sustain causes of action in certain cases brought against insiders. In Dirks, the court found that to sustain a cause of action against a "tipper" who does not trade, the Commission must demonstrate that the insider "tipper" benefited personally, either directly or indirectly.*** The subcommittee draft does not require that the tipper benefited, only that he communicated the information in violation of his "fiduciary or contractual obligations."

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* Chiarella v. United States, 445 U.S. 222, 239 (Burger, C.J. dissenting).

** The Second Circuit's decision in United States v. Newman, 664 F.2d 12 (1981) should, to a large extent, allay these concerns. The Newman court found that the breach of an employee's duty to his employer (an investment banker which had received nonpublic information from a client) had a sufficient nexus to the purchases in question to sustain an action under section 10(b).

*** Dirks v. SEC, supra. at p. 96129.

The draft also reflects a different approach to securities regulation--focusing on the misuse of information rather than the conduct of certain persons. The draft would enable the Commission to bring an action against a person based on his "unfair" use of information. Presently, self-regulators such as the NYSE and the NASD implement and enforce a comprehensive system of self-regulation and are authorized to initiate actions against regulated entities based on "fairness" concepts.* The NASD, for example, has extensive regulations aimed at promoting "just and equitable principles of the trade." The Commission's statutory mandate is to ensure full and accurate disclosure of the securities sold in interstate conduct and to prevent fraud in the sale of securities. We believe the existing statutory framework and system of self-regulation has served public investors well. The subcommittee draft would alter this historical division of regulatory responsibilities between the Commission and the self regulators. It applies fairness concepts where they have never applied.** We think it represents an imaginative and significant departure from existing statutes and merits careful examination. Our specific comments follow.

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* Exchange Act Section 15A(b)(6) requires the NASD to have rules designed "to promote just and equitable principles of trade." Section 6(b)(5) of the Exchange Act imposes identical obligations on registered securities exchanges such as the NYSE.

** In <u>Chiarella</u> the Court rejected the existence of any general duty (perhaps based in part on notions of fairness) between all participants in market transactions to forego actions based on material nonpublic information. 445 U.S. at 233.

The very use of the word "fair" in both the title of the statute and in paragraph (d) must be considered carefully. The use of a fairness concept, to some persons, may be viewed as an attempt to implement a system based on parity of information for all investors. We do not believe it is the subcommittee's intent to introduce a "parity of information" concept for all securities transactions. The Commission and Congress have both noted on several occasions that securities markets are largely dependent upon parties such as "specialists, block positioners and floor traders, who...contribute to the public nature of securities markets by risking their capital to absorb imbalances in supply and demand."* Such parties, by the nature of their position and function in the marketplace, often engage in securities transactions while possessing valuable "non-inside" information not generally known to the market. The Commission has recognized that:

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* See Adoption of Securities Exchange Act Rule 19b-2, Concerning the Utilization of Membership on National Securities Exchanges for Public Purposes, Securities Exchange Act Release No. 9950 (Jan. 16, 1973), 38 Fed. Reg. 3902, 3918 (Feb. 8, 1973). Accord, Securities Transactions by Members of National Securities Exchanges, Securities Exchange Act Release No. 15533 (Jan. 29, 1979), 44 Fed. Reg. 6084, 6088-6091 (1979); S. Rep. No. 94-75, 94th Cong., 1st Sess. at 68, 99; H.R. Rep. No. 94-123, 94th Cong., 1st Sess. at 57-72.

> market professionals have been permitted to enjoy these market information and competitive advantages because they have obligations to the markets for the securities that they trade and have made significant contributions to the continuity, liquidity and depth of the markets for those securities.*

Based on the language of paragraph (a), we believe that, notwithstanding the use of the word "fair" in the title of the draft, the subcommittee draft does not affect a broker-dealer's ability to effect transactions, while possessing nonpublic market information.**

The subcommittee draft does not define as unfair and unlawful all transactions by persons possessing material nonpublic information. We commend the approach, as we understand it, to incorporate existing case law by making unlawful transactions when certain persons "employ" tainted information. That is, to be unlawful, trades must be on the basis of tainted information. This language addresses one of the concerns we

* Securities and Exchange Commission, Report of the Special Study of the Options Markets, House Comm. on Int. and For. Commerce, Comm. Print No. IFC3, 96th Cong., 1st Sess. 1-4 (1978); accord 2 Report of the Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963). at 76-83, 90, 127-128, 135, 203-242; In re Albert Fried & Co., Securities Exchange Act Release No. 15293 (Nov. 3, 1978), 16 SEC Docket 100, 104 (Nov. 21, 1978) (The "quid pro quo" for conferring these advantages "has been the imposition of regulation to assure that in trading for his own account...[a dealer] uses those privileges for the benefit of the market generally...").

** See, e.g., the Court's discussion in Chiarella of Congress's decision to exempt specialists from certain provisions of Exchange Act Section 11(a)(1) wherein it stated: "[t]he exception is based upon Congress's recognition that specialists contribute to a fair and orderly marketplace at the same time they exploit the informational advantage that comes from their possession of buy and sell orders." 445 U.S. at 233, n.16.

expressed on the House Bill--its apparent failure to require that the tainted information be used by the alleged violator.*

As we understand it, the subcommittee draft also attempts to build on existing case law by making unlawful transactions if persons trade on the basis of material, nonpublic information if such use violates the person's own "fiduciary or contractual relationship." We believe such language is an attempt to incorporate concepts discussed in Supreme Court decisions such as Chiarella** and Dirks*** wherein the Court interpreted section section 10(b), an antifraud provision.

We are concerned, however, about the breadth of the prohibitory language in paragraph (a)--specifically, making unlawful the use of such information if such use is "in violation of [such person's] own fiduciary or contractual obligations." Such language introduces undefined concepts not currently found in the federal securities laws. Market participants have a myriad of obligations to customers, advisory clients, investment banking clients, and others. To make the violation of any such obligation the springboard for a treble damage action causes significant concern. In addition, this language could spawn

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* As discussed in the first note on page 4, supra., Chairman Shad implicitly acknowledged that the Commission's target in insider trading cases is persons effecting trades on the basis of certain information.

** In Chiarella, the Court stated that "a person violates section 10(b) whenever he improperly obtains or converts to his own benefit material nonpublic information which he then uses in connection with the purchase or sale of securities." Id. at 239 (Brennan, J., concurring).

*** See Dirks v. SEC at p. 96125, n.14.

years of litigation, the subject of which would be to define the precise contours of the covered fiduciary or contractual obligations.*

The subcommittee draft imposes liability on aiders and abettors. We have previously discussed the vagueness of such a provision and its interpretative problems in the context of H.R. 559. Assuming the subcommittee decides that liability should be imposed on persons other than those who profit from the trading in question, we suggest that the draft be revised to impose liability on those who "knowingly cause" such trading.

We commend and support the subcommittee's approach in paragraph (b). Such purchases involve neither the misuse of nonpublic information nor any violative conduct. Our only suggestion is that the term "offering person" be defined.

The first paragraph of section (c) tracks the language of paragraph (d)(2)(A) of H.R. 559. Our concerns as to the possible interpretations of this language are fully expressed on pages 7-9 of this submission. Suffice it is to say that it is unclear whether or not a firm is liable under this provision if it employs an agent-broker who may be deemed to "aid and abet" another person's violations by communicating tainted information if, for example, its supervisory systems were deemed inadequate.

The second paragraph of section (c) satisfactorily addresses

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* Similar language is used in paragraph (d). In proving its case, the Commission need only prove that the use of information was "unfair as violating an express or implied obligation." We are concerned about the vagueness of this language.

one of our principal concerns with H.R. 559. We believe the language used accurately reflects existing case law as expressed in the Commission's decision in the Investors Management case.* As the subcommittee draft makes clear, a multi-service firm such as a broker-dealer should not be subject to a penalty if one employee possesses material nonpublic information but another employee, not knowing of the information, trades for the firm's account. In such a case, there is no abusive conduct. Any statutory amendment aimed at providing the Commission with additional enforcement weapons should not be targeted at such activity.** We applaud the subcommittee's cognizance of this problem.

The relationship between paragraph (c)(1) and the preceding language "that employs another person who is liable under subsection (a)" needs some clarification. This phrase is not found in Exchange Act Rule 14e-3(b), upon which this provision is based.

Paragraph (d) reflects the subcommittee's conclusion that negligent actions (no scienter requirement) should be actionable. The language implementing this conclusion, however, is somewhat unclear. Paragraph (a) requires that certain persons, to be found liable, must have knowledge that they received the information in violation of the "tipper's fiduciary or

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* 44 SEC 633 (1971).

** See generally, Miller, Chinese Walls, 8 Rev. Secs. Reg. 865 (1975).

contractual obligations." In this instance, paragraph (a) reflects accurately existing law that "tippees" must "know or have reason to know"* the information was obtained in violation of the tipper's obligations. We suggest that that language be modified to address this apparent ambiguity. In addition, we question whether negligent conduct by insiders and their tippees should result, potentially, in the imposition of treble damages flowing from transactions they negligently caused.

As SIA has done previously, we strongly endorse the concept of increasing the sanctions against persons trading on the basis of certain material nonpublic information. We endorse the language of paragraph (e) which permits the Commission, and only the Commission, to bring such an action.

To address some of the concerns as to the language of paragraph (a), we suggest that the subcommittee's draft exempt from section 16(f) transactions effected by a market maker,** and activities which are a proper incident to such transactions. We believe an exemption is merited for two reasons. First, as noted previously, both Congress and the Commission have recognized that

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* Dirks, supra. at p. 96127, n.20.

** Section 3(a)(38) of the Exchange Act defines "market maker" as follows:

> The term "market maker" means any specialist permitted to act as a dealer, any dealer acting in the capacity of block positioner, and any dealer who, with respect to a security, holds himself out (by entering quotations in an inter-dealer communications system or otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis.

while market professionals often engage in transactions while possessing material, nonpublic market information, the public benefits from such activities.* Second, the Commission has acknowledged, "it is not necessary to seek the proposed penalty against...a broker or dealer because Section 15 of the [Exchange Act] provides ample deterrence for such violations of the security laws."** Corporate insiders and their tippees are the proper targets of this legislation.

We note that the subcommittee draft proposes to amend Exchange Act Section 16. Section 16 has, historically, applied only to corporate officers, directors, and 10% shareholders. Through the mechanism of disclosure and profit recapture, it "regulates" the conduct of statutory insiders. It provides for liability without fault, while the subcommittee's draft addresses the conduct of "outsiders" who know they have received information in violation of certain obligations. To some extent, therefore, the subcommittee's draft introduces a state-of-mind requirement not previously contained in Section 16. These factors should be considered by the subcommittee.

Summary

On balance, we believe the subcommittee draft represents an interesting first step in addressing some of the thorny issues surrounding trades effected on the basis of material nonpublic information. We commend the subcommittee's attempt to fill in

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* <u>See</u> text at pages 15-17, <u>supra</u>.

** House Report at p. 28 (letter of Chairman Shad).

Senator D'Amato. Thank you very much, Mr. Miller.

Mr. Freeman, now that we've had a thorough analysis in respect to the proposed legislation in the draft, how do you respond to Mr. Jacobs' contention that section A in the draft bill is narrower than the current law?

FORM OF BILL MAY BE TOO BROAD TO BE ADOPTED

Mr. Freeman. Well, I heard him say that it was narrower and then that he thought the word unfair made it broader. I was on the phone yesterday with a senior partner of a New York law firm almost as distinguished as Mr. Jacobs' law firm and he had the idea that the form of the bill was entirely too broad to be adopted.

What I would suggest—and I don't know that you can persuade everybody, but I would like to persuade this committee that the right thing to do is to take the approach, for example, that Mr. Miller and to a certain extent Mr. Jacobs also has taken, to make specific suggestions, not as to whether it's too broad or too narrow, but how it could be changed in order to be more widely accepted. Thus, if some want the word unfair taken out of there or whether the word should be kept is I believe a proper subject of discussion. Certainly the question of an exemption for market makers is a properly specific subject for consideration.

I hope that the committee will say to everybody who's here who has given valuable consideration to all of these matters, that it would appreciate specific language with an explanation as to why they believe the draft should be amended.

Now I have taken exception to the fact that the draft which is circulated, unlike an earlier draft, applies to the use of any material public information even though it is not specified to be of a kind which would reasonably be expected to affect the market. I think that's wrong. I think that's the point Miss Colish made and I'd like to have the language that was in there when we discussed the matter with the SEC reinstated. So as far as I know, nobody really wants this new supplemental provision to apply to information that is material for purposes of being disclosed in a registration statement, but would not affect the market. So what we're talking about are things like a tender offer or a cut in the dividend or something of similar nature that may be reasonably expected to affect the market.

I hope such a provision will be put in the bill. I would hope that others who have suggestions as to what should be put in or what should be taken out would come forward, so that you and your staff may examine it and report to your committee on the details of a draft. I believe overall the approach of having a separate supplemental bill which would give the SEC additional powers is a reasonable thing. I hope you will conclude that it is and I hope that the SEC will also conclude that it is. If there are specific things that can be improved in the bill, which I certainly will not assert is perfect, that the specific suggestions be made as they have been made here by some of the witnesses.

Senator D'Amato. Mr. Miller, do you think the scope of the legislation that is before us today is too broad or too narrow in terms of the definition?

Mr. MILLER. I don't think it's too broad, with the caveat of the suggestions that we made about changing the language. I guess I don't think it's a matter of breadth or narrowness so much as refining the definition of some of the concepts in the bill.

Senator D'AMATO. Mr. Jacobs, under the current law the insider only owes a fiduciary duty to corporate shareholders. Those who don't aren't really considered insiders.

In the proposed draft the language refers to breaching a fiduciary or contractual obligation not necessarily owed to a shareholder. Therefore, wouldn't you consider that to be much broader than narrower?

Mr. JACOBS. As I understand the existing law, Senator, there are three ways in which you can become an insider and therefore be subject to the prohibitions of rule 10b–5 against insider trading.

First, there's a fiduciary duty. That fiduciary duty is not limited to just insiders, officers, directors, and controlling persons, but goes to a broader class of people.

Second, under existing law, people who are held in a trust and confidence kind of relationship would be subject to the law. There was some talk about the reporters and whether or not they have a duty not to trade on the basis of insider information.

I think a splendid argument could be made that reporters are subject to rule 10b–5 today because the public puts trust and confidence in the news media.

Finally, we have misappropriation about which a lot of words have been spoken today. So I do think the bill as drafted is considerably narrower than existing law.

Senator D'AMATO. Let's take the case where we have a tipper who passes on information that results in someone making large profits as a result of this inside information. Should that person be liable for treble damages?

Mr. JACOBS. In my own personal opinion, yes, sir.

Senator D'AMATO. Does anybody else want to comment?

Ms. COLISH. I have been thinking about that, where you have a group of people, two, three, six, seven people, all of whom are participating in a single transaction where, let's say, a $100,000 profit that Chairman Shad posited as a hypothetical is gained. You could have an astronomical amount of total penalty. I don't at the moment have language for you, but a thought that I've been turning over is whether it would be possible to limit the total penalty of three times the benefits to all the participants in the scheme. But I do think that the person who breaches his duty by giving the information should be subject to a penalty, whether three times $100,000 in addition to the $300,000 that the actual trader might have to pay, it might get to be excessive.

Senator D'AMATO. Mr. Freeman or Mr. Miller, would you care to comment?

Mr. FREEMAN. Well, I have no concern with the draft that I have proposed. I think it specifically gives the court authority to treble the damages. I have no concern with the extent of the penalty.

I have no objection to treble damages and I haven't paid much attention to that. The point I'm making is that there is a practice going on out there which in my judgment in many cases is not ille-

gal under existing court decisions, and it's appropriate as a matter of public policy that the practice should be outlawed.

Senator D'AMATO. Mr. Miller.

Mr. MILLER. Well, I agree with Mr. Freeman that as I understand your example, assuming the tippee knowingly received forbidden information, he should be subject to a penalty and I think certainly treble damages is an appropriate one. I don't think there's a lot of activity out there, as Mr. Freeman does, that is not picked up under section 10(b) and the rule thereunder, but I think his draft and the subcommittee's draft makes that easier to get at.

I think it's illogical and unfair for the Commission to have to plead some of the twisted and in some cases salacious facts that it does to get at that behavior.

HOUSE WIDE OPEN UNDER PRESENT CASE LAW

Senator D'AMATO. Well, I thank you for that observation because that is exactly what has taken place. Under case law you can come in through the side door and the back door and the windows. We say when we apply the case law in this manner that the statute never really envisioned us to get to the wrongdoer, and I think that's really unfortunate. For those who say, well, we've got this body of case law and let's not tamper with it, I really can't believe that we should not deal legislatively with a situation where there are glaring deficiencies in the statute in terms of its application. Let me conclude by saying that I want to commend Congressmen Dingle and Wirth for their efforts in determining and bringing forth this very important matter on insider trading.

I want to thank the witnesses as well and all others who have contributed to the dialog on this important issue because it is important to the securities industry, to the investor, and to the general public. I think it's important that we have appropriate penalties. We have a legislative initiative which would deal with those who would break the law and a statute which is clear, and permits the SEC to fulfill its mandate.

I think today's witnesses and their testimony is most helpful and will be helpful to this committee in attempting to deal with this problem.

The question of whether we need a definition, what type of definition—those are important questions. I think we have to devote our energies to this issue in order that we see to it that those who would cheat, those who are indeed criminals, who trade while in possession of inside information at the others' expense, that there be appropriate penalties and that the law be clear as to what kinds of conduct are proscribed.

So, while we have to protect the investors, we also have to preserve the integrity of the capital markets. Therein comes the balance that Ms. Colish talked about. It is easier said than done. We are certainly not looking to disrupt capital formation of the marketplace which we have, which is second to none in the world, but I think protecting the integrity of the system is our goal.

As I said, we don't have pride of authorship as such and I want to thank Mr. Freeman for his credible and valuable contribution along with the others. We are going to review this record very

carefully. I would welcome any additional suggestions or comments that you might have individually or from your associations.

Thank you so very much. This hearing is adjourned.

[Whereupon, at 12:05 p.m., the hearing was adjourned.]

[Additional material supplied for the record follows:]

April 3, 1984

STATEMENT OF WILLIAM D. HARRINGTON, ASSOCIATE PROFESSOR OF LAW, ST. JOHN'S UNIVERSITY SCHOOL OF LAW, TO THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, SUBCOMMITTEE ON SECURITIES

My name is William D. Harrington and I am an Associate Professor of Law at St. John's University School of Law in New York City.

I appreciate the opportunity to comment on the proposed legislation, S. 910, which is designed to amend the Securities Exchange Act of 1934 (the "Act") to increase potential sanctions against trading in securities while in possession of material nonpublic information and which is an analogue, if not a counterpart, of H.R. 559, passed by the House on September 19, 1983. While I have taught, written and practiced in the securities law field, the suggestions which I would offer today are my own, are not made in any representative capacity, and do not necessarily reflect the position of any professional association to which I belong or of the educational institution with which I am affiliated.

I support wholeheartedly the purpose of the proposed legislation -- to give the Securities and Exchange Commission (the "Commission") the authority to seek from a court a civil monetary penalty of up to three times the profit gained or loss avoided by anyone who purchases or sells a listed security while in the

possession of material nonpublic information with respect to an issuer or the trading market for an issuer's securities, or who aids and abets such activity by "tipping," and to increase the maximum fine for criminal violations of the Act from $10,000 to $100,000.

Notwithstanding the enhanced enforcement efforts of the Commission in the last six years to detect and prosecute insider trading cases, it has become obvious that the core remedies currently available to the Commission -- injunction and disgorgement -- are inadequate as deterrents. The risks of detection are widely and all-too-accurately perceived as minimal and the opportunity to reap large profits by trading on material inside or "market" information not available or accessible to the public is perceived as far outweighing the risk of the wrist-slap of an injunction and the economic fact that disgorgement places the trader in no worse a position than he was in before he acted. The unfortunate and, in my view, unwarranted principles articulated by the Supreme Court in Chiarella v. United States, 445 U.S. 222 (1980) and Dirks v. Securities and Exchange Commission, ___ U.S. ___ (1983) have exacerbated the problem: in its crabbed construction of the Act as requiring that the duty to either disclose inside information or abstain from trading can arise only out of a "relationship of trust and confidence," such as a fiduciary relationship, the Court has emasculated the deterrent effect of potential liability in civil damages to contemporaneous traders on the other side of the market, with whom the informationally

establishing a "disclose or abstain" doctrine rather than as creating a direct prohibition against trading on the basis of material nonpublic information. Once the Commission and the courts became enmeshed in the "disclose or abstain" formulation, as they did in In re Cady, Roberts & Co., 40 S.E.C. 907 (1961) and S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir.) cert. denied, 394 U.S. 976 (1969), it was inevitable that the scope of the duty to disclose would become an issue. When this occurred, the Court unfortunately embraced the narrow, anachronistic common law deceit notion that a duty to disclose material facts of a transaction to the other party (as distinguished from a duty not to affirmatively misrepresent those facts) can only arise out of a special relationship between them, a relationship of trust and confidence, which obviously cannot exist (in its classic common law sense) between complete strangers who deal only through impersonal market transactions. As a result of the "fiduciary duty" rationale of Chiarella and Dirks, the possessor of material nonpublic information who trades on it cannot be reached under section 10(b), at least by a contemporaneous trader claiming damages, absent a special relationship of trust and confidence with traders on the other side of the market; and a trading or re-tipping tippee cannot be reached unless (1) his tipper first breaches his own fiduciary obligation (by disclosing the information in the first place), (2) the tippee knows or should know of the breach, and (3) the initial tipper will derive some personal benefit from tipping the information.

without informational advantages of a compensatory remedy, supply exploiters of inside information with the argument that, by its silence after reviewing the area, Congress impliedly ratified and adopted the Chiarella-Dirks principle, and, most importantly, eviscerate the Act of its major deterrent in respect of insider trading: the threat of civil damages in private actions.

The second concern I wish to address is the "definition problem" -- the view expressed by some that a bright-line hard-and-fast definition of insider trading should be included in the proposed legislation. I would urge that such a definition not be included: it is not necessary, it is not practicable, the effort to include it will either substantially delay or permanently derail legislation which is badly needed, and the wiser and more effective policy choice is to leave definitional implementation to the courts.

I. THE PROPOSED LEGISLATION SHOULD AMEND SECTION 10 TO OVERRULE THE CHIARELLA-DIRKS PRINCIPLE AND REESTABLISH A PRIVATE CAUSE OF ACTION FOR CONTEMPORANEOUS TRADERS AGAINST INSIDER TRADERS, SUBJECT TO A CEILING ON DAMAGES.

While I happen to believe, with respect, that the specific results which the Supreme Court reached in Chiarella and Dirks were incorrect, the real danger that these cases have created lies not so much in their results as in their reasoning. At bottom, the Chiarella-Dirks principle derives from a fundamental misperception of the Act (and of rule 10b-5 thereunder) as

establishing a "disclose or abstain" doctrine rather than as creating a direct prohibition against trading on the basis of material nonpublic information. Once the Commission and the courts became enmeshed in the "disclose or abstain" formulation, as they did in In re Cady, Roberts & Co., 40 S.E.C. 907 (1961) and S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir.) cert. denied, 394 U.S. 976 (1969), it was inevitable that the scope of the duty to disclose would become an issue. When this occurred, the Court unfortunately embraced the narrow, anachronistic common law deceit notion that a duty to disclose material facts of a transaction to the other party (as distinguished from a duty not to affirmatively misrepresent those facts) can only arise out of a special relationship between them, a relationship of trust and confidence, which obviously cannot exist (in its classic common law sense) between complete strangers who deal only through impersonal market transactions. As a result of the "fiduciary duty" rationale of Chiarella and Dirks, the possessor of material nonpublic information who trades on it cannot be reached under section 10(b), at least by a contemporaneous trader claiming damages, absent a special relationship of trust and confidence with traders on the other side of the market; and a trading or re-tipping tippee cannot be reached unless (1) his tipper first breaches his own fiduciary obligation (by disclosing the information in the first place), (2) the tippee knows or should know of the breach, and (3) the initial tipper will derive some personal benefit from tipping the information.

It need not have been thus at all. In the first place, the Act had as one of its principal designs the creation of new remedies to supplement what were viewed as the inappropriately narrow remedies afforded in the state courts, bound as they seemed by common law fraud and deceit. And in the second place, the Court did not have to reject, as in effect it did, the "information" theory of the prohibition against insider trading, i.e., the perception that the prohibition rests on the unfairness, the inequity, of using an informational advantage that other traders, irrespective of their intelligence, skill and diligence, cannot possibly overcome because they are not legally entitled to it and may not properly have access to it. Such an interpretation of the Act's prohibition is emphatically not a requirement of parity or equality of information; it is merely an interpretation of the rule as a prohibition against using information which no one -- neither the user nor other traders -- is entitled to use. The prohibition is rooted not in equality of outcome, but in equality of access to material information: that one trader may exercise more skill or diligence in gathering, analyzing or using information to which all have access is not and should not be the concern of the prohibition. This structural premise permeates the entire continuous disclosure system created by the Act.

The proposed legislation presents an opportunity to overrule the Chiarella-Dirks principle before it becomes too encrusted in our jurisprudence to remove. I do not advocate this step lightly because my deep respect for the Court as an institution gives me

great concern that any Congressional overruler of a decision tends to undercut the Court's authority and stability. In the matter at hand, however, the reasons for overruler are too many and too compelling and the principle of Chiarella and Dirks too threatening to both market efficiency and market integrity: the success of our capital markets is intimately tied to their perception as being open and fair.

The decision in the Moss case which I referred to earlier also illustrates the impotence, in the area of civil damages for insider trading, of the alternative "misappropriation" theory suggested in the Chief Justice's dissent but pretermitted by the majority on the ground that it had not been adequately presented to the jury. In United States v. Newman, 664 F.2d 12 (2d Cir. 1981), aff'd after remand, ___ F.2d ___ (2d Cir. 1983), cert. denied, ___ U.S. ___, 52 U.S.L.W. 3240 (1983), decided prior to Moss, the Second Circuit had held that criminal liability for insider trading could be predicated on allegations of fraud practiced by the defendants on the bidders in the relevant tender offers on the theory that the defendants had misappropriated confidential information from their investment banking employers, whose clients were those bidders, and from the bidders themselves; the court held that such a criminal breach of section 10(b) could be sustained without regard to any preexisting duty or other relationship between the defendants and the targets' stockholders from whom the defendants purchased based on their inside knowledge.

In Moss, however, the court held that private plaintiffs from whom the same insider had purchased securities on the basis of the identical tip could not state a cause of action against the defendant for civil damages on the misappropriation theory because no Chiarella-Dirks duty to the sellers had been breached in the absence of the requisite "relationship of trust and confidence."

My point is this: if the court's interpretation of the Chiarella-Dirks principle in Moss is accurate -- as I believe it is -- then that principle has effectively rung the death knell for the private cause of action for damages against inside traders.

Restoration of the private cause of action for damages against traders on material nonpublic information via restatement of the rule as a prohibition rather than in terms of the misleading and inaccurate "disclose or abstain" formulation will, of course, enhance the deterrent function that lies at the heart of the proposed legislation. I would emphasize two aspects of this enhanced deterrent. First, it is important, in my view, that the Commission not be given sole "prosecutorial" discretion in this area. The complaint that the Commission has not been as vigorous as it could or should have been over a consistent period of time either in its enforcement efforts or in the sanctions it has sought is hardly a new one. And the concern that narrow political considerations may sometimes affect enforcement and sanction decisions is a very real one which has been expressed not without

apparent foundation. In the second place, I appreciate the concern that the potential liabilities to other traders in the markets might be vastly disproportionate either to the gains made (or losses averted) by an offending trader or to the relative seriousness of the offense. This concern can be properly assuaged in two ways: by limiting the class of recovering plaintiffs to contemporaneous traders, see, e.g. Wilson v. Comtech Telecommunications Corp., 648 F.2d 88 (2d Cir. 1981), and by capping a defendant's potential aggregate liabilities in precisely the manner in which both S. 910 and H.R. 559 would do in their current forms with respect to the proposed civil penalty under consideration. Alternatively, consideration could be given to putting a ceiling on recoverable damages at the amount of gain made or loss avoided by an inside trader. See, e.g., Elkind v. Liggett & Meyers, Inc., 635 F.2d 156 (2d Cir. 1980); American Law Institute, Federal Securities Code §§ 1603, 1703, 1708, 1711 (1980).

There is one final reason which weighs heavily in favor of overruling the Chiarella-Dirks principle: the risk that a court will construe a Congressional failure to act on it in the context of this consideration of insider trading sanctions as constituting a general reappraisal of insider trading law such as to warrant the inference of an implied adoption or ratification of the Court's decisions and rationales in Chiarella and Dirks, thus precluding the Court from reconsidering its rulings or underlying justifications. This theory of statutory interpretation has

never been viewed as particularly meritorious either by the Court or by scholars. Yet in two very recent and important decisions, one in the area of commodity futures and, more alarmingly, one in the area of securities, the Court used this theory as a principal rationale for its decisions. Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 456 U.S. 353 (1982); Herman & MacLean v. Huddleston, ____ U.S. ____, 103 S.Ct. 683, 74 L.Ed.2d 548 (1983). That I happen to agree with the result in each case is both irrelevant and unimportant; what is relevant and important is the new vitality and respectability which the Court has conferred on the implied-ratification-by-silence theory of statutory interpretation. My concern, of course, is that if, in the course of this review, Congress determines to allow the Chiarella-Dirks principle to stand, this review will be characterized as a "comprehensive reexamination" of insider trading law warranting the inference that, in failing to amend the Act in respect of the principle, Congress affirmatively adopted the principle. At the very least, therefore, I would urge that the Subcommittee use every effort to have the legislative history make clear that such an interpretation of the proposed legislation would be erroneous.

II. CONGRESSIONAL DEFINITION OF ABUSE OF POSSESSION OF MATERIAL NONPUBLIC INFORMATION IS BOTH UNNECESSARY AND COUNTERPRODUCTIVE.

In their present forms, neither S. 910 nor H.R. 559 contains a definition of insider trading. On balance, and recognizing that

the arguments of proponents of a definition are not spurious, I would urge that the Subcommittee resist incorporation of a definition: it is unnecessary, it is impracticable, an attempt to incorporate it will substantially delay and possibly permanently derail this needed legislation, and the better policy choice, in my view, is to leave definitional implementation to the courts.

A. Necessity

I respectfully disagree with the assertions made by some that it is somehow "unfair" to impose or increase legislative sanctions such as those embodied in the proposed legislation without a concrete definition of the predicate act. Existing law with respect to the content of the prohibition has been evolving for decades and is embodied in hundreds of decided cases, with the consequence that in the overwhelming majority of cases it is clear what conduct the law proscribes. Introduction of a new definition will result, not in new clarity, but in new uncertainties and new interpretive issues which will take years of costly litigation to resolve.

B. Practicability

The efforts both of the drafters of the American Law Institute's Proposed Federal Securities Code and of the staff of the Commission in drafting definitions for possible use in connection with the proposed legislation demonstrate the difficulties of the definitional problem. The tension between the competing goals of clarity and flexibility in this area is not

susceptible of easy resolution. A choice in favor of more clarity by attempting a bright-line definition will rigidify and retard healthy development of the law in this area on a case-by-case basis, will create substantial risks of under-inclusion, will most probably result in an only slightly less generalized prohibition than that of current law, and will almost surely have an unintended spillover effect on other areas of securities law. The costs associated with the definitional proposal far outweigh the perceived benefits, to the extent the latter are not illusions, particularly if you agree with my conclusion that there is already sufficient clarity of content in the current state of the law.

C. Delay

The effort to pass this much-needed legislation has already met with substantial delay. If the Subcommittee determines to pursue a bright-line definition, the project will take years of man-hours and testimony toward an elusive, unneeded and probably unattainable goal. Pursuit of this goal will create a tangible and substantial risk that this important and needed legislation will never make it to the floor. I do not share the cynical belief of some that permanent derailment of the proposed legislation is precisely the intent of at least some of the definitional proponents; at the same time I am not so naive as to miss the plausibility of such an outcome if definition is permitted to become a major legislative issue.

D. Judicial Implementation

The definitional problem which has been posed in connection with the proposed legislation is hardly new or unique; the same problem arises with any broad anti-fraud provision. In the insider trading arena, however, the courts have labored for decades in the context of hundreds of cases to give content to the definition. And in the vast majority of cases they have been successful. Such uncertainty as exists is at the fringes rather than at the core, and the core accounts for the overwhelming majority of cases that arise. A minimum amount of uncertainty at the fringes is not too severe a price to pay to preserve flexibility to deal with new abuses as they arise. The courts have interpreted the prohibition's content with utmost good sense and it is a fair expectation both that they will continue to do so and that the Commission and courts will wisely use the discretion given them in the proposed legislation with respect to the imposition of sanctions in unusual cases involving violations at the margin rather than at the core. Giving definitional content to a flexible term on a case-by-case basis is a task which the courts are especially well-suited to perform, as has been demonstrated for years in the insider trading cases. The process has worked wisely and well and has produced a coherent, consistent, principled and predictable body of case law defining insider trading. In short, there is no convincing reason to inject new uncertainties into the area and invite the risks of underinclusion,

while there is every reason to continue to leave the definitional task and responsibility to the courts.

In summary, I support wholeheartedly the purpose of the proposed legislation, I urge that it be amended to overrule the Chiarella-Dirks principle insofar as that principle will continue to stifle the collateral and complementary remedy of the private action for damages under section 10(b) and rule 10b-5 thereunder, and I respectfully recommend that the Subcommittee resist the arguments of those who believe that attempting to draft an all-encompassing bright-line definition is either necessary or wise: it is neither.

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